

ORIGINAL



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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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ARIZONA CORPORATION COMMISSION
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Arizona Corporation Commission

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IN THE MATTER OF THE COMMISSION'S
GENERIC EVALUATION OF THE
REGULATORY IMPACT FROM THE USE OF
NON-TRADITIONAL FINANCING
ARRANGEMENTS BY WATER UTILITIES AND
THEIR AFFILIATES

Docket No. W-00000C-06-0149

The Global Utilities,¹ file the attached workshop presentations that were presented at the workshop on February 25, 2011, by Paul Walker, Graham Symmonds and Matthew Rowell, together with the source documents referenced in the presentations, as shown in the list of documents below:

1. "Acquisition Adjustments and Rate Premia", presented by Paul Walker;
2. "Consolidation and Regionalization", presented by Graham Symmonds;
3. "The 1999 Water Task Force: Acquisition Adjustments and ROR Premiums", presented by Matthew Rowell;
4. Arizona Corporation Commission, "Interim Report of the Arizona Corporation Commission's Water Task Force", dated October 28, 1999.
5. Arizona Corporation Commission, Decision No. 62993 dated November 3, 2000;
6. Commission Approved Returns on Equity (ROE) For Other Arizona Utilities (2004-2010);
7. Public Utility Reports, Inc., ROE Surveys for 2006, 2007, 2008, 2009 and 2010; and
8. S&P, "Assessment of Regulatory Climate Investor Owned Utilities", dated November 25, 2008.

¹ Hassayampa Utility Company, Inc., CP Water Company, Global Water – Picacho Cove Utilities Company, Global Water – Picacho Cove Water Company, Global Water – Palo Verde Utilities Company, Global Water – Santa Cruz Water Company, Valencia Water Company – Town Division, Valencia Water Company – Greater Buckeye Division, Water Utility of Greater Tonopah, Inc., Willow Valley Water Co., Inc., Water Utility of Northern Scottsdale, Inc. and Balterra Sewer Corp.

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Acquisition Adjustments and Rate Premia

Acquisition Adjustments: An increase to utility rate base which reflects the cost of the purchase of the utility or the asset.

Rate Premium: An increase to the allowed return on equity as an incentive for certain investments.

CAVEAT

- Groups who will not agree with this presentation:
- Parties which support Acquisition Adjustments and Rate Premia as regulatory means to encourage consolidation,
- Parties which expect Utility shareholders to “foot the bill” for consolidation,
- Parties looking for an easy solution.
- The purpose of this presentation is not to be the “skunk at the picnic” but to provide investment perspective on the suggested tools.

Basis for Opinion

- 11 years' experience at the ACC, four as advisor to Commissioner and Chairman Marc Spitzer,
- 7 years' experience advising Wall Street firms on utility acquisition cases in several states,
- 7 years' experience working with regulated water and wastewater companies,
- 4 years' experience assisting with acquisitions in Arizona.

Acquisition Adjustments

- Staff Testimony in Global's rate case (2010):
- Q: And can you tell me how many times you are aware of that the Commission has approved a positive acquisition adjustment relating to the acquisition of a small water company by a large water company or utility holding company?
- A: Two. [Tr. Page 788 - 789]

Acquisition Adjustments

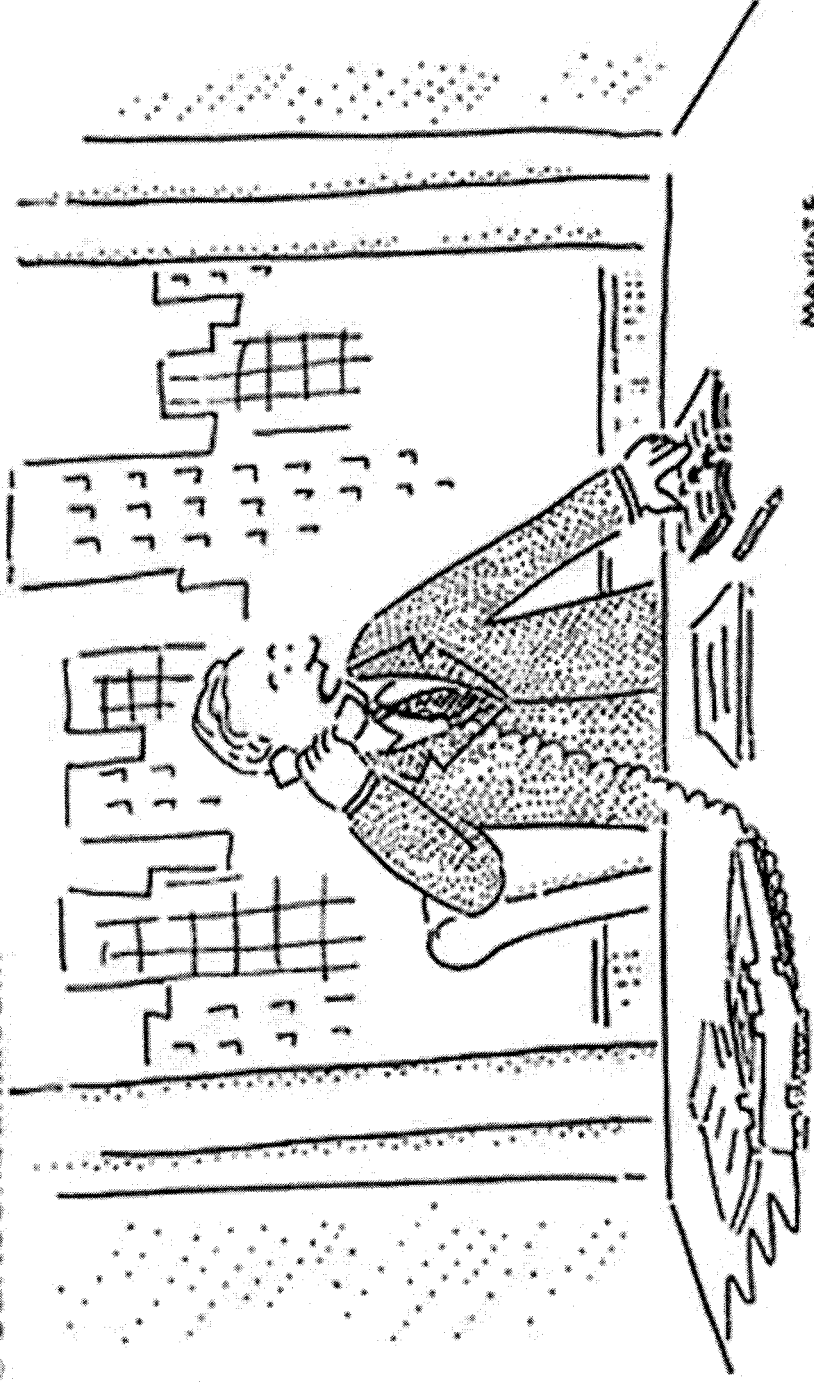
- Staff Testimony in Global's rate case (2010):
- Q: Two. Could you specify what those were?
- A: [Algonquin]... and previous to that – it's just because I've been here so long – there was a small company called Cool Wells in what is now, in the Sun City area. And Citizens bought it. He had 11 customers... and Citizens bought it for something like \$10,000 and the Commission gave citizens the acquisition adjustment." [Tr. Page 789]

Acquisition Adjustments

- RUCO Testimony in Global's rate case (2010):
- Q: [Did RUCO ever] propose or support an acquisition adjustment?
- A: No. And RUCO wouldn't have because typically the Commission doesn't allow acquisition adjustments to be included in rate base... [Tr. Page 658]
- Q: And have you ever testified in support of an acquisition adjustment in any proceeding whatsoever?
- A: None that I'm aware of. [Tr. Page 658]

Acquisition Adjustments

©Cartoonbank.com



MANUSCRIPT

"No, Thursday's out. How about never—is never good for you?"

Presented to ACC Water
Workshop Feb. 25, 2011

Acquisition Adjustments – Recommended Policy Language

- “Acquisition adjustments are a potentially useful tool that the Arizona Corporation Commission may, in limited circumstances, approve in order to encourage the acquisition of a troubled utility.”

A Rate Premium

- AUTHORIZED ROE

+

- ROE PREMIUM

=

- COST OF EQUITY

The theory is to provide a return *above the market level* in order to attract investment.

Staff Testimony on Rate Premia in Global Rate Case

Q. Okay. And then in the next sentence it lists possible methods, other methods of encouraging consolidation, such as rate of return, premiums, or deferred accounting orders; is that right?

A. I see that.

Q. To your knowledge, how often has Staff recommended either of those alternative methods in acquisitions?

A. There may have been a deferral when -- when Arizona-American acquired Citizens there wasn't a determination. Arizona-American wanted a determination that they would get the acquisition adjustment in rate base...

Q. Okay. And, to your knowledge, was Arizona-American ever successful in getting that acquisition premium?

A. I don't think they were.

Q. And other than that possible example, to your knowledge, how often has the Commission approved either those methods in acquisitions?

A. I don't know of any. [Tr. Page 835]

Rate Premia in Arizona – “Average” is not an incentive

- Arizona has consistently ranked as one of the Bottom 5 states for utility investment climate
 - Standard & Poors’ “Assessment of Regulatory Climate for Investor Owned Utilities” reports
- Public Utility Reports’ November 2010 ROE survey shows that Arizona was the only state in the nation handing out 8% ROEs

**Rate Premia in Arizona – “Average” is
not an incentive**

- **Arizona’s average ROE of 9.29 in 2010 was
lower than 99.2% of the ROEs granted
nationwide**
- Public Utilities Report, ROE Survey, November 2010

Rate Premia in Arizona – “Average” is not an incentive

- S&P ~ 85% of U.S. IOUs are investment grade
- Arizona Regulated Utilities
 - APS: BBB- (lowest investment grade)
 - TEP: BB+ (below investment grade)
- Arizona’s non-Regulated Utility
 - Salt River Project: AA (high investment grade)

Arizona has a bad investment climate for water and wastewater companies

Until we deal with that reality, we will not see meaningful consolidation

- Gold Canyon Sewer Rate Case

- Customers should only pay for the average peak capacity of a system, not the actual peak.

- Global Water's Rate Case

- Utility investors should bear the costs of regional acquisitions.

- Arizona-American - White Tanks Regional water plan

- Cooperative efforts with cities and developers were ignored.

Arizona ROEs

- **10 ACC Decisions for Water and Gas Utilities in 2010**
- **Average ROE:**

9.29%

- Adding 100bp = 10.29
- 10.29% was the ACC's average ROE in 2007.

U.S. ROEs

- 115 ROE Decisions nationwide; 97 with Public ROE #s
- 14 Decisions nationwide granted an ROE < 10%
- 9 decisions nationwide within 50 basis points of 9.29% (Arizona's average ROE)
- Only 1 decision nationwide below 9.29%
(AmerenCIPS – Gas in Illinois received 9.19%)

- Public Utilities Reports November 2010 ROE Survey

Presented to ACC Water
Workshop Feb. 25, 2011

U.S. IOU Average ROE in 2010

- From Public Utilities Report, November 2010 Annual ROE Survey
- 115 Cases, 97 publicly available ROEs
- U.S. AVERAGE ROE

10.34%

105bp above Arizona's ROE...

Presented to ACC Water
Workshop Feb. 25, 2011

ROE Premium in Arizona

● 9.29% ROE

+

● 100bp Rate Premium

=

10.29 ROE --- Near the U.S. Average

Guess who's coming to the 10.29
discussion?



Water
, 2011

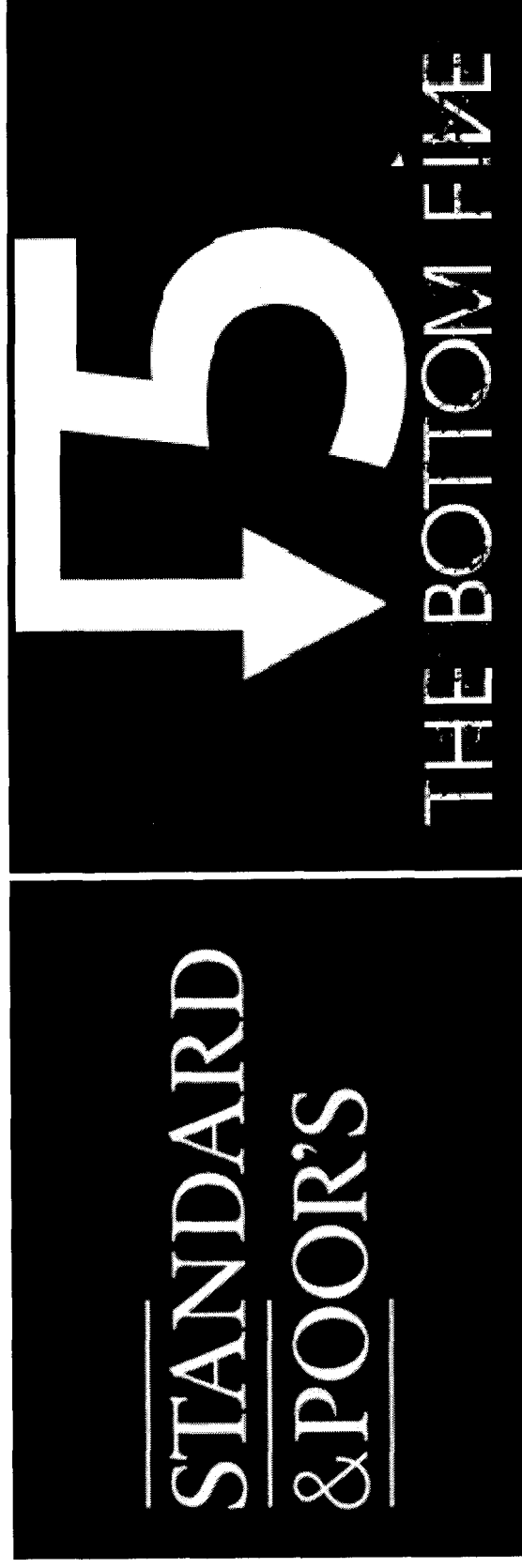
What is the Public Interest?

- RUCO
 - The broad public interest is served by keeping rates as low as possible.
 - [Arizona Republic, “APS argues against free power lines to homebuilders”, August 25, 2009]
- Angry Customers’ View
 - Rates should be low, period.
- Bonbright View
 - “[S]ound ratemaking policy is a policy of reasonable compromise among partly conflicting objectives.”
 - James Bonbright, Preface, Principles of Public Utility Rates, 1961
- Arizona Constitution
 - The ACC shall balance the needs of shareholders and customers.

Presented to ACC Water
Workshop Feb. 25, 2011

Rate Premium – Arizona's Reality

- The ACC provides lower-than-market ROEs and therefore, the rate premium option will not work in Arizona.



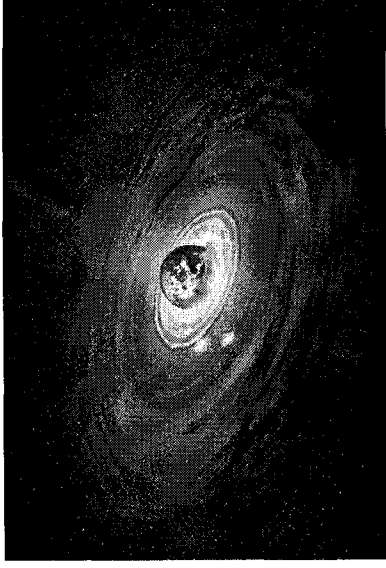
Acquisition Adjustments – Recommended Policy Language

- “Acquisition adjustments are a potentially useful tool that the Arizona Corporation Commission may, in limited circumstances, approve in order to encourage the acquisition of a troubled utility.”

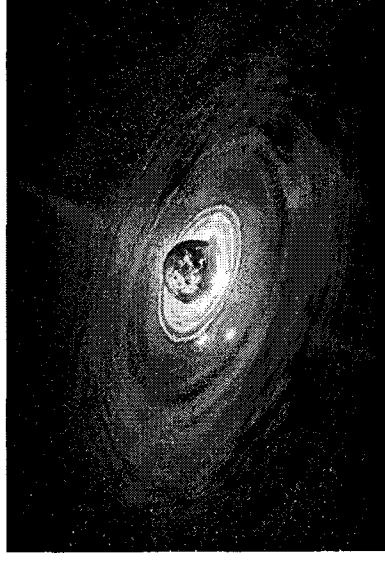
Negative & Nil Rate Bases

- Any number multiplied by $0 = 0$.
- Any number multiplied by a negative yields a negative.

10.29% *



=



Negative Rate Base & Acquisition Adjustments

- Trevor Hill Testimony in Global's last rate case:
- Mr. Pierce: So, many [acquired companies] have negative rate base?
- Mr. Hill: It's true. It's true. Many, many of these companies have negative rate base.
- Mr. Pierce: But [buyers] pay fair market value for them?
- Mr. Hill: We do.
- Mr. Pierce: So the delta in that is something that would either have to be acquired through an acquisition adjustment or eaten by the shareholders?
- Mr. Hill: Those are your choices.

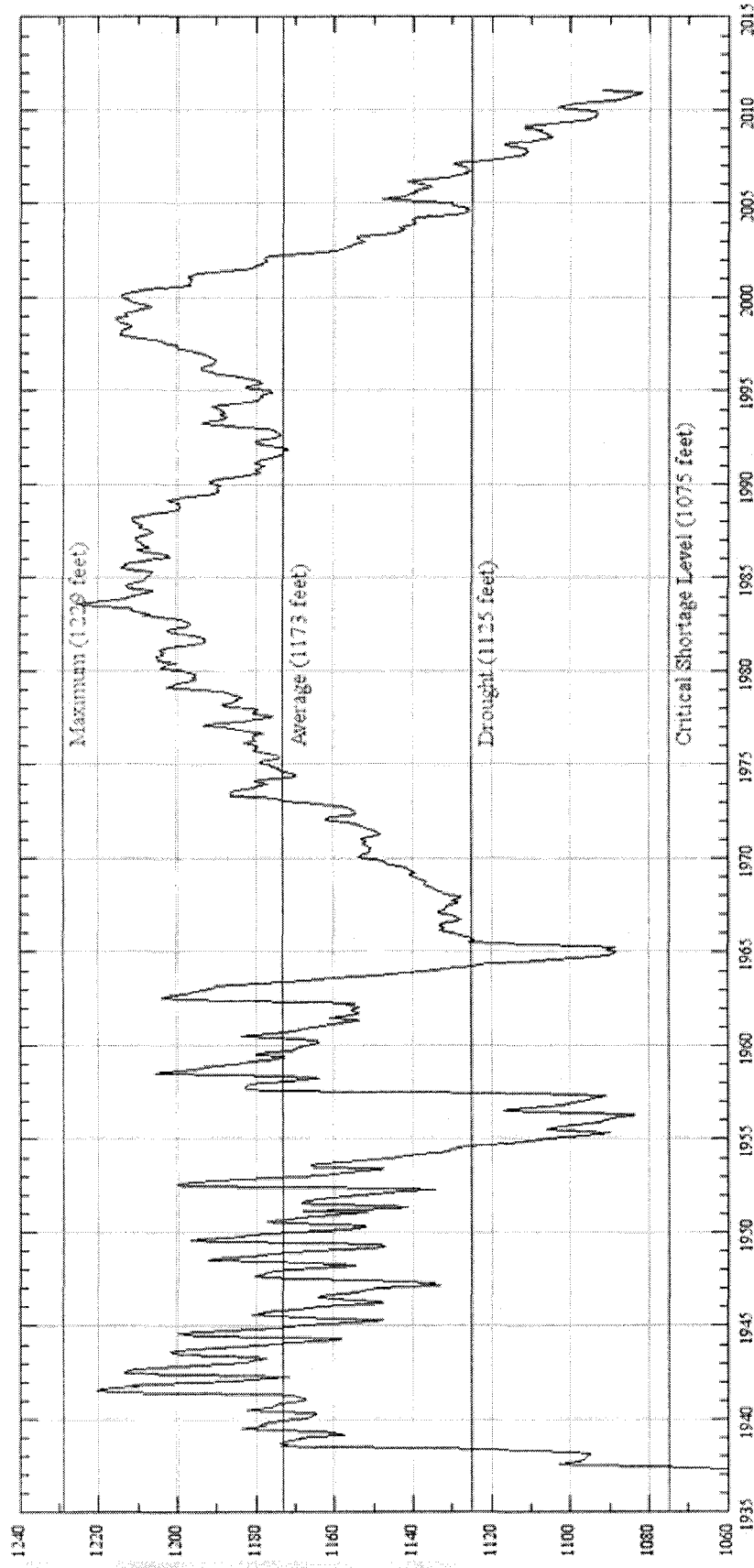
Summary Points

- Negative & Nil Rate Bases destroy the chance to use Rate Premium or Acquisition Adjustments
- Acquisition Adjustments have never been supported by RUCO.
- Acquisition Adjustments have only been approved in two cases in 20 years – they are not politically practical.
- A Rate Premium in Arizona would only move the ROE to a point near the national average – which is, by definition, not an incentive.

Consolidation and Regionalization

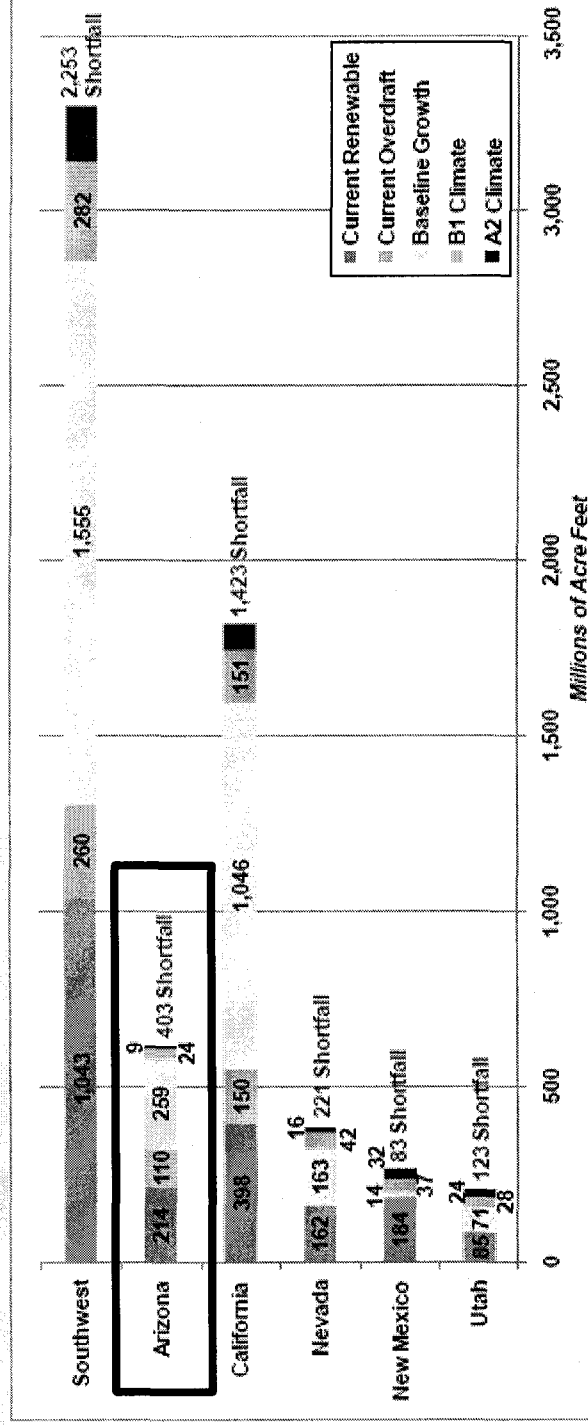
Graham Symmonds
Global Water

Surface Water Availability



Graph from <http://www.arachnoid.com/NaturalResources/>. Data from <http://www.usbr.gov/lc/region/g4000/hourly/mead-elv.html>

Groundwater Overdraft



Note: Shortfall = sum of all groundwater use, beyond the renewable (blue) level, under A2 climate assumptions.
Source: Authors' calculations. For California, Stanton and Fitzgerald (2011).

Frank Ackerman, Elizabeth A. Stanton "The Last Drop: Climate Change and the Southwest Water Crisis", Stockholm Environment Institute-U.S. Center, February 2011

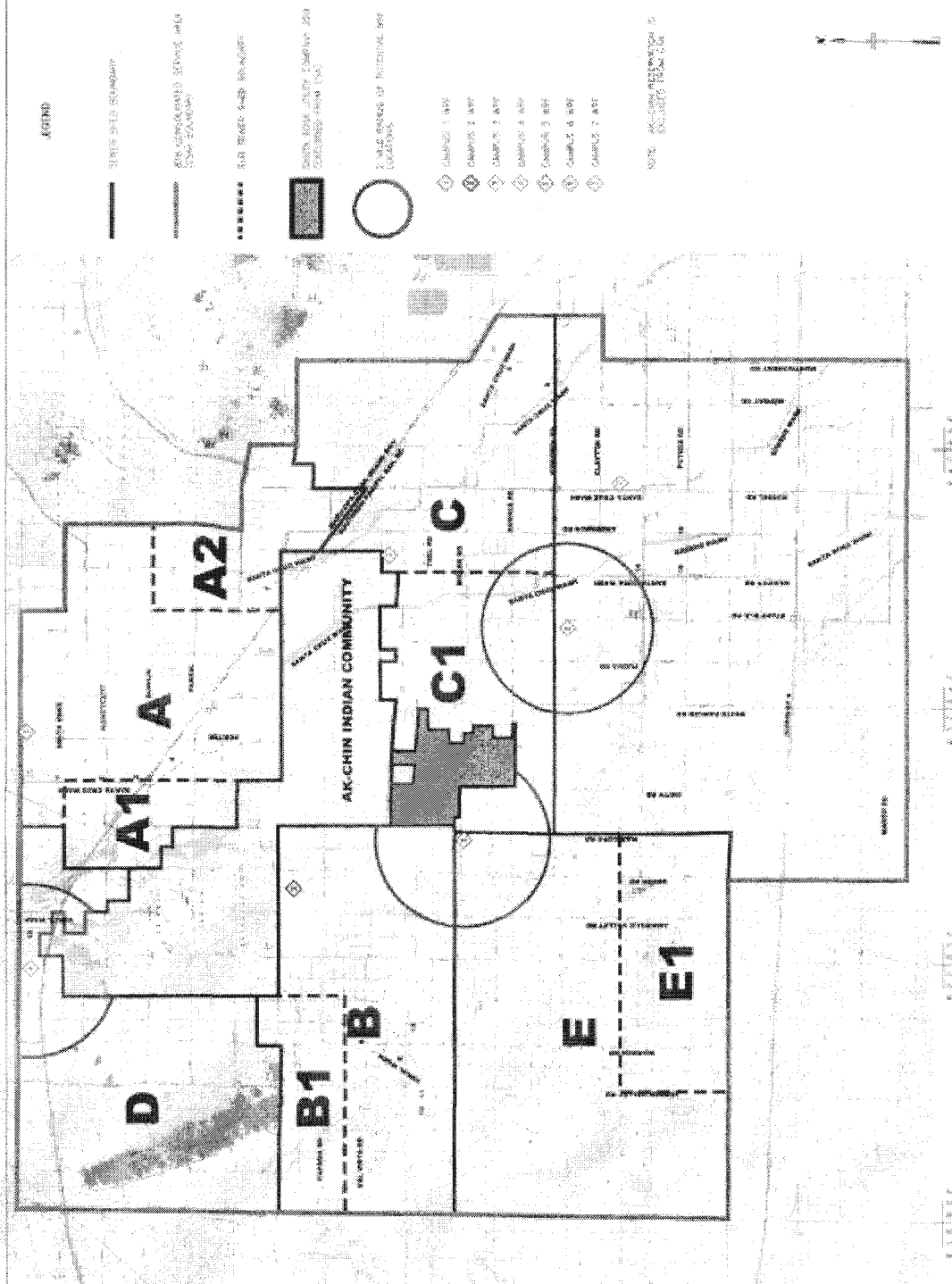
Regionalization

- Integrated Water/Wastewater/Recycled Water utilities
- “Right water for the right use”
- Recycled water permanently supplants potable water use
- Regional scale infrastructure
- Regionalized treatment
 - Hexavalent chromium
 - Fluoride
 - Perchlorate

Benefits of Consolidation and Regionalization

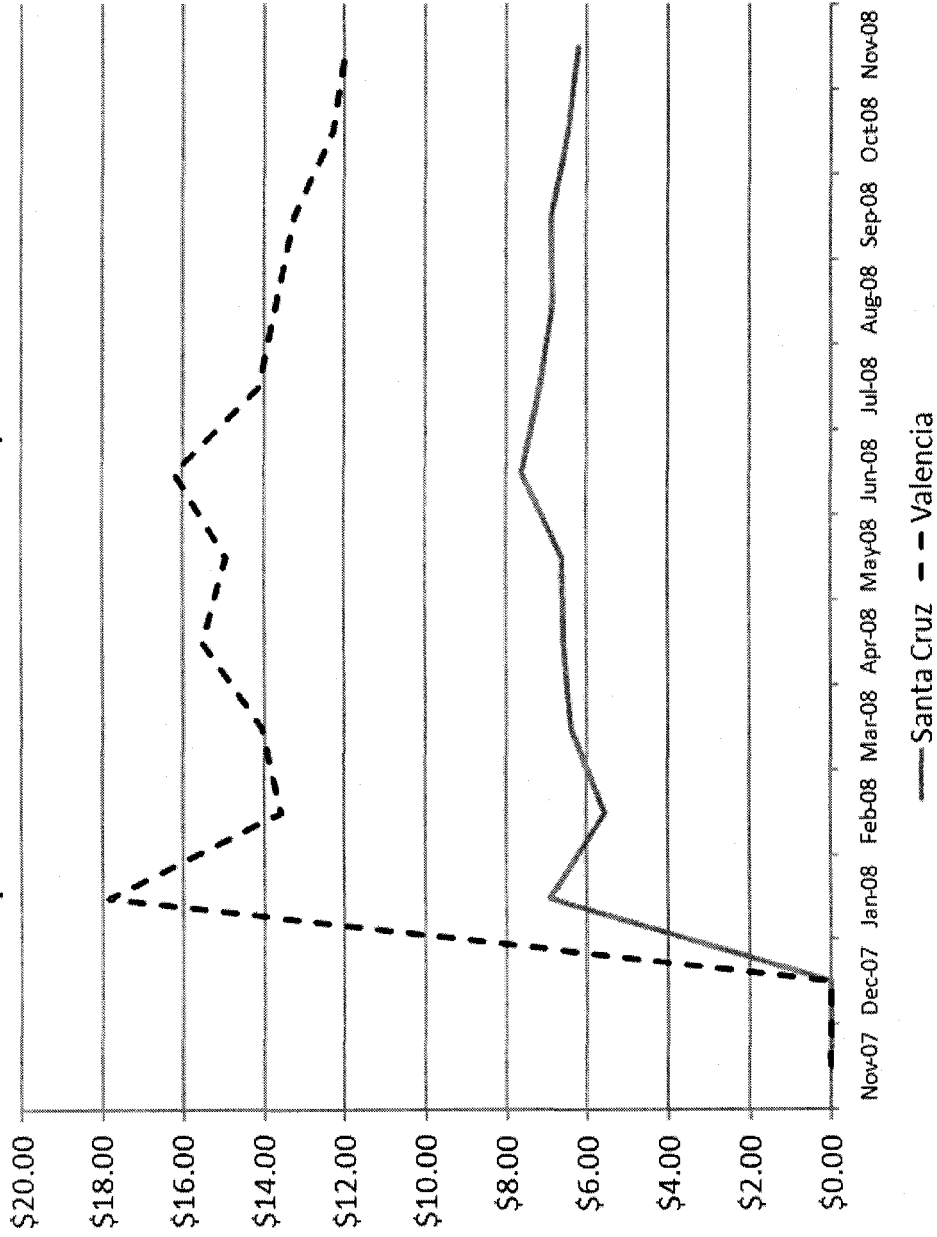
- Economies of Scope
 - Integrated Water Resources Management
 - Water/Wastewater/Recycled Water
- Economies of Scale
 - Management efficiencies
 - Engineering
 - Operations
 - Customer Service
 - Equipment and infrastructure can be operated at its most efficient points
- Conservation
 - Total Water Management

Regionalization



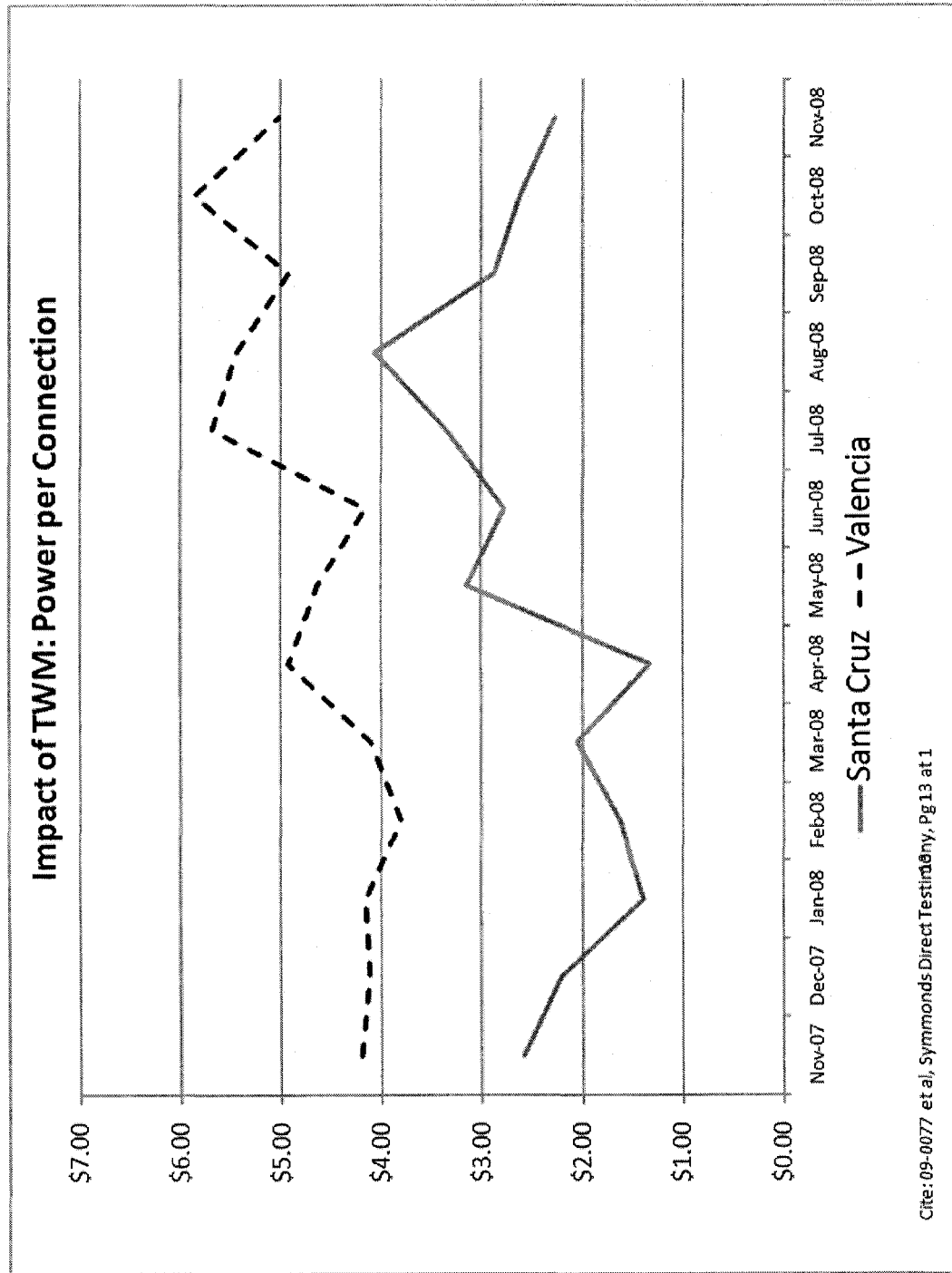
Economies of Scale

Impact of TWM: Labor Costs per Connection



Cite: 09-077 et al Symmonds Direct Testimony, Pg 15 at 1

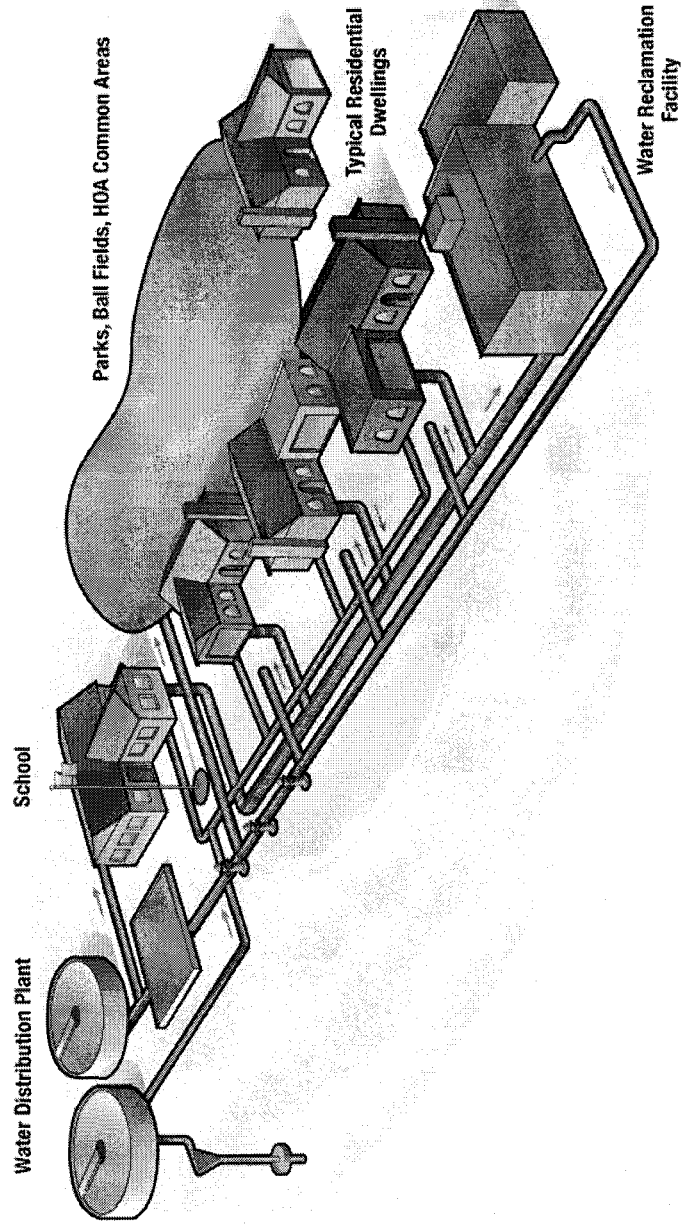
Economies of Scale



Cite: 09-0077 et al, Symmonds Direct Testimony, Pg 13 at 1

Conservation

Advanced Recycling – 100% Ground Water



Achieving the Sustainable Growth Corridor

- Consolidate planning and service areas
 - Investment in SERVICE AREA
 - Ensuring utilities are financially prepared for growth
 - Encouraging the consolidation of smaller, undercapitalized utilities
- Regional facilities designed and built for managing water scarcity
 - Investment in PLANT
 - “municipal scale” infrastructure
 - Appropriately delivered (Just in Time) and appropriately sized
 - Planning and permitting completed well in advance of development
- Sustainable water supplies
 - Investment in RENEWABLE SUPPLIES
 - Recycled water and surface water

Regulatory Constructs to Ensure Efficient Oversight of the Regulatory Corridor

Define the Public Interest as sustainable water delivery

- Short, Medium and Long-Term Water Resources Management Plans
- CAPEX Plans
- Development Plans

Require conservation oriented infrastructure

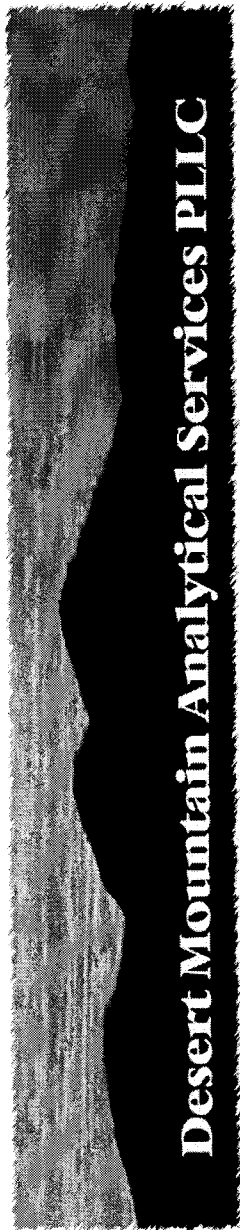
Seek integration of water/wastewater services

Regulatory Constructs to Ensure Efficient Regionalization of the Growth Corridor

- Consolidation must result in improved regional water resource planning and conservation.
- Consolidation must result in an increase in technical, managerial and financial capabilities for the acquired company.
- Develop policies to encourage consolidation and minimize impact to consumers.
- Consider alternative financing opportunities (eg ICFAAs).
- Discourage “cherry-picking”

Summary

- The ACC has a large role in managing the Growth Corridor
- Consolidation and Regionalization can provide direct benefits for water resources management in Arizona
- Consolidation and Regionalization can provide direct benefits for consumers in Arizona
- These benefits can only be realized within the context of an enabling regulatory structure



The 1999 WATER TASK FORCE: Acquisition Adjustments and ROR Premiums

Background on WTF

The Task Force was established in April 1998 in Decision No. 60829:

- A steady supply of potable water is essential
- Conservation is critical
- The Safe Drinking Water Act substantially increased costs
- Increased costs require new efficiencies and streamlined regulatory processes

Background on WTF (continued)

- Increased communication among government agencies and water companies regulated by those agencies are needed to create a sound statewide water policy
- The ACC as the regulatory body with the longest history and the primary responsibility over private water companies should take the lead in seeking a coordinated solution to the problems facing small private water companies^{MR1}

Background on WTF (continued)

The task force was made up of

- Representatives from small and large water companies,
- customers of small and large companies,
- Reps. From AZDWR, ADEQ, CAWCD,
- RUCO,
- One ACC Staff member appointed Chairman of the Task Force.

Background on WTF (continued)

- In October of 1999 the WTF's Report for the Commission was docketed and comments were solicited
- In November of 2000 the Commission endorsed most of the recommendations from the report in Decision 62993

Consolidation

- All WTF members agreed that the ACC should
incent large financially sound water companies to
purchase and rehabilitate smaller or non-viable
water companies.
- No agreement on what the incentives should be
 - Staff and the industry favored acquisition adjustments
 - RUCO favored ROR premiums, Surcharges, or deferral
accounting orders

Consolidation (continued)

The WTF did not see consolidation as the primary means of solving the problems associated with small non-viable water companies

Incenting consolidation was just one of many proposed policies

Why Incent Consolidation?

Customers are at risk when small utility owners do not have access to capital for necessary system improvements.

(Consolidation is not the only solution to this problem.)

Acquisition Adjustments

Staff recommended that an Acquisition Adjustment should be adopted if the following circumstances are met:

1. The acquisition is in the public interest
2. The acquisition will not negatively affect the viability of the acquirer
3. The acquired system's customers will receive improved service in a reasonable time frame

Acquisition Adjustments (continued)

4. The purchase price is fair and reasonable (even though it may be more than book value) and conducted through arms length negotiations
5. The recovery period for the acquisition adjustment should be for a specific minimum time (e.g., 20 years)
6. The acquired company is Class D or E

Acquisition Adjustments (continued)

The Commission ultimately endorsed these conditions (and applied them to ROR premiums as well)

Negative Acquisition Adjustments

All parties to the WTF agreed that negative acquisition adjustments should never be granted.

The Commission essentially imposed a negative acquisition adjustment on WUGT in Global's last rate case

Alternatives

- ROR premiums: Given the low rate bases of many small systems, they are regulated on an operating margin basis so an ROR premium would not apply.
- Surcharges for capital investment or accounting deferrals for extraordinary repair and maintenance: could be provided without an acquisition

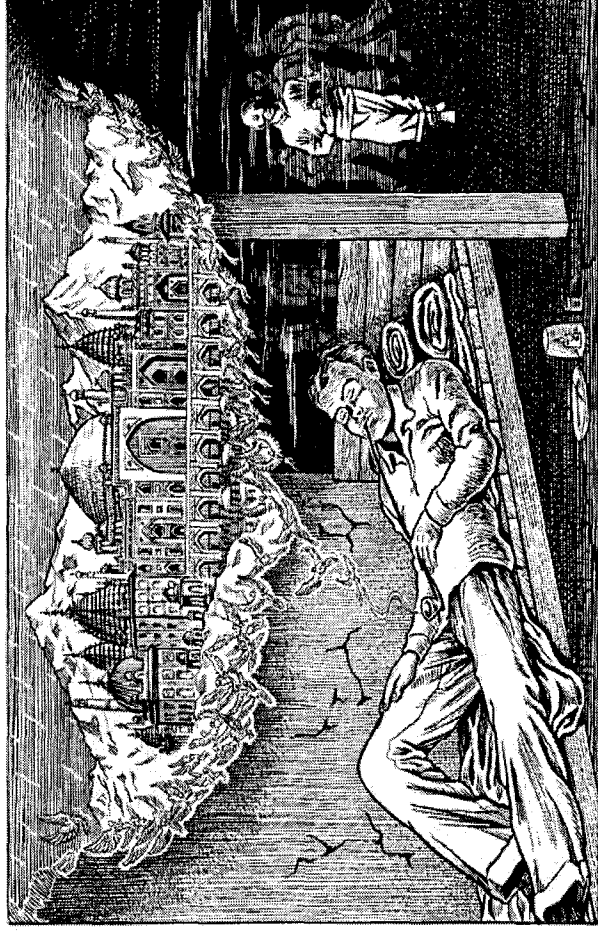
Alternatives

Acquisition adjustments and the above discussed alternatives require customers to pay more.

Global's ICFA concept allows for acquisitions without customers paying more. However, this use of the ICFAs was not accepted by the Commission.

Hindsight

While we were enthusiastic about consolidation at the time of the WTF, in hindsight, significant consolidation of small water systems is a pipe dream.



Hindsight

Acquisitions of *troubled* companies are impossible without acquisition adjustments or some other regulatory incentives.

But even with those incentives such acquisitions ***are not likely to be widespread.***

Hindsight

This is especially true for small utilities that are not located in the Phoenix-Tucson “growth corridor” or that are distant from larger utilities’ existing service territories.

MR2



Hindsight

Opportunities to achieve operational economies of scale are limited with small systems that are geographically dispersed.

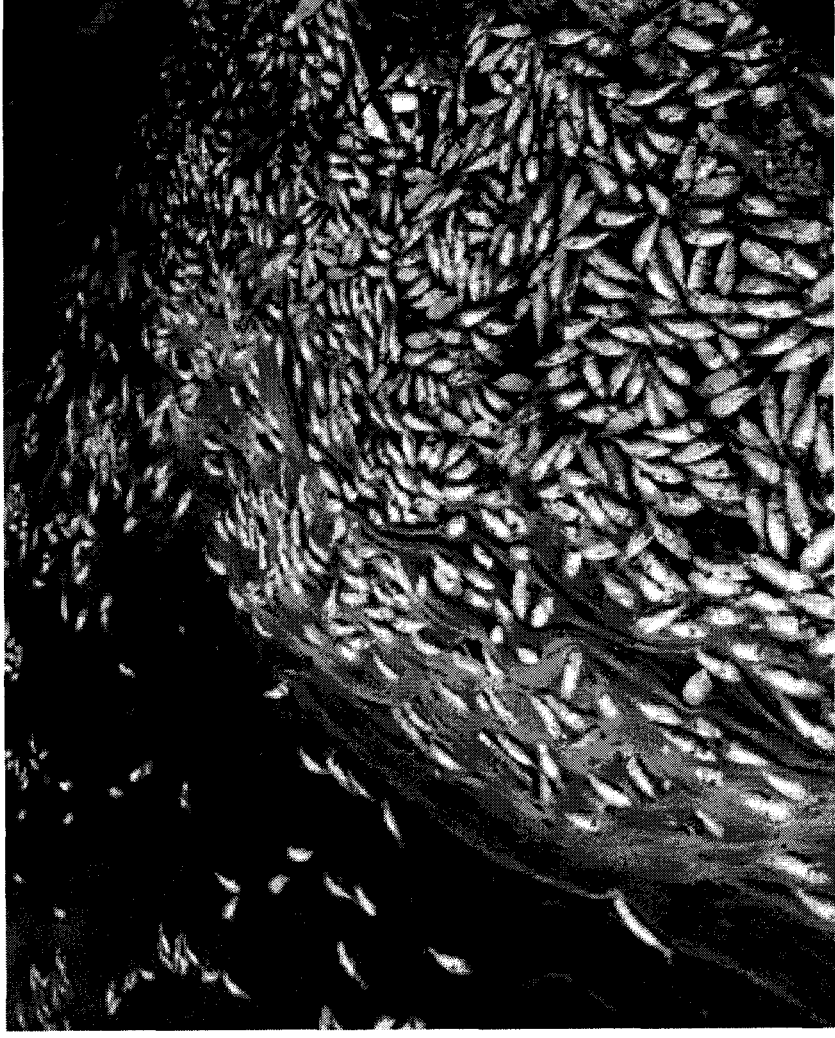
Hindsight

Consolidation alone is unlikely to result in a significantly healthier industry on a state wide basis.

A healthier industry would lead to more consolidation.

Hindsight

Would you want to fish in this lake?



To improve the prospects of small water utilities the ACC should seek to make the regulatory process more efficient and pursue policies that result in adequate revenue requirements.

Regulatory Process Efficiencies:

- Consider the WTF's recommendation regarding automatic rate changes tied to the CPI (not adopted by ACC) (An alternative is to allow adjusters for electric rates, property taxes etc.)
- Consider WTF's policy on post-test-year plant (adopted by ACC)
- DSIC
- Rationalize the ACC policy regarding operating margins (WTF Report: Operating Margins should be used in conjunction with DSICs.)
- Establish Generic Rates of Return
- Review Filing Requirements

Regulatory Process Efficiencies

Recommendation:

One day workshop dedicated to discussing ways to make the rate case process more efficient.

Agenda should be open to ideas from the WTF as well as new ideas.

TAB 4

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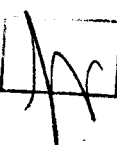
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**Interim Report of the Arizona Corporation Commission's
Water Task Force**

October 28, 1999

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I. INTRODUCTION

The Commission's Water Task Force was established by Commission vote on April 24, 1998 and held its first meeting on September 22, 1998. The Task Force's members include consumers, water company representatives, and representatives from the Arizona Department of Water Resources (ADWR), Arizona Department of Environmental Quality (ADEQ), and the Central Arizona Conservation District (CAWCD). The Task Force's meetings are open to the public and several individuals who are not official "members" of the Task Force have taken on active roles. The goal of the Task Force is to develop policies to address a wide variety of problems that private water companies and their customers face. The Task Force has divided into three subcommittees: the Regulatory Reform Subcommittee, the Water Supply Subcommittee, and the Conservation Subcommittee.

This report represents the accomplishments of the Task Force to date. The Task Force was able to agree on what the problems facing the water industry in Arizona are. The Task Force members proposed many possible solutions for these problems. Consensus was reached on some of these proposed solutions. However, the Task Force was divided on the appropriateness of many of the proposed solutions. The report that follows summarizes each of the proposed solutions. The positions of the Task Force members will be presented in a pros and cons format. The members whose views are presented in this report fall into four categories: the industry (consisting of representatives from Brooke Utilities, Inc., Arizona Water Company, Big Park Water Company, and Citizens), the Residential Utility Consumer Office (RUCO), the ADWR, and Commission Staff.

II. REGULATORY REFORM SUBCOMMITTEE

The Regulatory Reform Subcommittee reached the consensus that the following five goals would be their focus:

1. Reduce the number of small, non-viable water systems through new rules and procedures.
2. Strengthen the financial capacity of the water utility industry.
3. Provide greater emphasis on simplifying, shortening, and reducing the cost of the ratemaking process.
4. Improve Consumer Education.
5. Increase Interagency Coordination.

- 1. Reduce the number of small, non-viable water systems through new rules and procedures.**

Many of Arizona's water companies are quite small; the majority of them have less than \$250,000 in annual revenues. Although some small water companies are well run and provide quality service to their customers, many of these small companies are quite problematic. Most of the "problem" companies that the Commission must deal with are quite small. Because of their small base of customers, even quality managers of small companies may find it difficult to raise sufficient revenues to make needed capital investments. The Subcommittee decided that it was not necessary or desirable to establish criteria for identifying a non-viable company.

Also, because of economies of scale, larger companies are likely to be more efficient. A larger company can consolidate the administrative aspects of many smaller "systems" thereby significantly reducing the overall cost of service.

For these reasons the Task Force agrees that reducing the number of small non-viable water systems is a desirable goal. Two areas of Commission policy were discussed for addressing this goal: CC&N applications and consolidation.

CERTIFICATES OF CONVENIENCE & NECESSITY (CC&N)

The Task Force members reached consensus that the Commission must eliminate the establishment of additional non-viable water companies. Therefore, the requirements for establishing new water companies should be made more stringent.

Commission Staff recommended the following Commission policy changes concerning the establishment of new water companies:

1. The application for a new CC&N must show that an existing water company cannot or will not serve the area being applied for. This showing must be made by submitting service rejection letters from all the "A" size water companies in the state (there are 3) and at least five of the "B" size companies (there are 20). The application must also be accompanied by service rejection letters from all the existing water companies within five miles of the area being requested. In addition, the rejection letters must be accompanied by the corresponding request for service that was made to each of the existing water companies by the applicant.
2. The rates could be set such that the company should break even no later than its third year of operation and should achieve its required rate of return no later than its fifth year of operation. The calculations would be based on the company's estimates of customer growth.
3. Because Staff believes that it is not in the public interest, no new CC&N would be issued to any company that was in any way affiliated with any other company or person that was not in compliance with Commission and ADEQ requirements.

4. The rates and tariff establishment portion of the CC&N approval process could be simplified by changing Staff's entire approach to rate review for new CC&Ns. Staff recommends that instead of trying to determine if rates are too high for new CC&Ns, it should be examining if rates are too low. Staff recommends establishing a set of standard non-monthly charges. These standards could be set by looking at the average of the rates that are charged by other Commission regulated companies or possibly even include municipalities. These charges could include such things as late fees, establishment fees, NSF check fees, etc.

For the monthly minimum and commodity charges, Staff should establish some standard that would be a minimum. For example, the standard for the monthly minimum for a 5/8-inch x 3/4-inch meter could be \$25.00 with no gallonage. Therefore, all new CC&N applications for water companies would be reviewed to determine if the rate was at least that much.

As for the commodity charge, the standard could be an inverted tier rate with three tiers. The first tier could be \$1.50 per thousand for the first 3,000 gallons. The second tier could be \$4.00 per thousand for the next 7,000 gallons. The third tier would be 2-times the second tier per thousand for all usage over 10,000 gallons. Although, the numbers used here are just examples, all new companies should have a three tier inverted rate. (See Section III on conservation for more on three tiered rates.)

With the type of standards as discussed above, the rate review portion of new CC&N applications could be done by the Commission's Consumer Services section by simply comparing the requested rates against the standard. If the requested monthly rates were below the standard, Staff would recommend that the Commission approve the standard rates. If the rates requested were above the standard, Staff would recommend that the Commission approve the company requested rates. This would provide much more time for the Accounting & Rates Staff to work on actual rate and financing cases.

Staff believes that the only segment of the population that may be against having Staff determine if rates are too low for new CC&Ns, are developers. Many of the troubled water companies that the Commission regulates today are a result of developer owned water systems that had their initial rates approved as low as possible, at the request of the owner. The reason for doing this was that it was a selling point for the developers. Although the Commission should be concerned for all segments of the Arizona population, including developers, the concern for developers should be second to that for the water company customers and the water companies themselves, especially with regard to the establishment and granting of new CC&Ns.

The Commission's Legal Staff has indicated that there are no significant legal barriers to placing the proposed limits and conditions on CC&N issuance. The Commission has wide latitude and sole jurisdiction in this area.

The industry members of the Task Force indicated that they support most of Staff's recommendations concerning CC&Ns. RUCO had significant objections to Staff's proposals, they will be summarized in the pros and cons section below.

PROS AND CONS

PROS

1. The Task Force agrees that Staff's proposals offer an effective method for limiting the number of small water companies.

CONS:

1. (Staff and RUCO) The initial rates may be set too high allowing the company to over earn.

Staff believes that this concern is mitigated by the following factors: First, the chance of any company over-earning in the first few years of existence is very small. Second, in all these new CC&N approvals, the Staff would recommend that the Commission require the company to file a full rate case within a specified timeframe. If in that first rate case Staff determines that the company is over-earning, Staff could recommend lower rates. Staff believes that it is much easier for the Commission to lower rates than it is to raise them. Third, there are no customers when these rates are set. Any person that becomes a customer does so with the full knowledge of what the rates are. That person becomes a customer by choice, instead of having high rates levied against him *after* becoming a customer.

RUCO believes that this proposal ignores the potential negative consequences of excessive initial rates. For example, customers may be driven away. Potential customers that would have preferred buying homes and beginning businesses in the service territory may select alternate locations. Taken to an extreme, a CC&N could be used to postpone growth in the service territory by charging excessive rates. A CC&N holder with the objective of limiting growth could prevent a developer from building in the service territory by charging grossly excessive rates that no reasonable customer would pay. Also, the cost of service varies significantly by location. No single standard rates will prevent all new water companies from charging inadequate rates. New companies can benefit by the input from Commission Staff, RUCO, and other intervenors in setting rates. Prospective customers will also benefit from the input of multiple parties in developing a probable on-going level for rates in a new water system.

RUCO also believes that establishing standard, minimum monthly customer charges and commodity rates does not ensure a proper balance of revenue from each. A company could choose the minimum monthly customer charges and select commodity rates far in excess of the minimum resulting in an unstable revenue base. Without an analysis of a company's projected underlying costs, the appropriate balance for a given company is unknown. Also, if a company were to choose an inappropriate balance for its initial rates, an unnecessarily large change in the rate structure may be warranted in a future rate case. Avoidance of large changes in rate structure is one of the fundamental goals of rate design. In addition, the proposed minimum rates fail to address other issues including conservation objectives, the high cost of CAP water, and special customer demands, such

as those of a prospective industrial user. The scrutiny provided by Staff, RUCO, developers, and hearing officers is valuable in forming appropriate initial rates and should not be discarded. Furthermore, providing water companies with full initial rate setting discretion is certain to be ill received by the public and public criticism could bring embarrassment to the Commission and RUCO even if real problems did not exist with the proposal.

2. (RUCO) The proposal creates a hierarchy of preferential treatment for various existing companies. An existing company will not necessarily make a more-fit public service provider than a new company. A small or newly formed water company is not necessarily non-viable or unfit to provide public utility service. Also, it is dubious that any pre-determined distance can be established that will represent the distance from which another water company can effectively service any new service territory

3. (RUCO) Large, existing water companies may not be interested in expansion. Company's that are not interested in new service territories may be reluctant to assert that disinterest in a rejection letter. Also, new applicants could seek rejection letters only from those "Class B" companies that always reject proposals for new service territories. This would circumvent the intent of requiring a new CC&N applicant to obtain rejection letters from at least five "Class B" water companies as one of the criteria for obtaining a CC&N.

4. (RUCO) This plan also suggests using only the water company's projected customer growth estimates in setting rates to achieve break-even operating results no later than the third year of operation and for earning the authorized rate of return in the fifth year of operation. RUCO believes that other parties (e.g., RUCO, Staff, Hearing Officers, Commissioners, developers, prospective customers, and others) may have valuable input into the growth projections.

5. (RUCO) The complete compliance with ADEQ requirement is a desirable goal. However, it may be preferable to establish a lesser standard that allows some latitude. For example, a water company in complete compliance could acquire a company in non-compliance resulting in a circumstance that the acquiring company is no longer in compliance and, accordingly, not eligible for the new CC&N. In this instance, the proposed condition provides an undesirable result. Also, a large company with many systems is statistically more likely to have a violation than a smaller company. The proposed condition, therefore, discriminates against large companies and is counter-productive in the effort to reduce the number of small, non-viable companies.

The industry and Staff recognize the validity of many of RUCO's concerns. However they believe that Staff's proposal is fundamentally sound and that RUCO's concerns can be addressed when a more detailed proposal is produced.

INCENTIVES FOR CONSOLIDATION

All of the Task Force members agree that the Commission should implement new policies that provide incentives for large financially sound water companies to purchase and rehabilitate water systems that are small or non-viable. The members could not come to agreement about what the incentives should be.

Also, the industry believes that incentives for consolidation should apply to all water companies since they believe that consumers benefit from the economies of scale realized by the combination of merged entities regardless of the individual sizes of acquiring companies. RUCO is opposed to any policies that are not limited to small systems since if an "A", "B" or "C" size company wants to merge with another such company, it should be strictly a business decision with no need for incentives. Commission Staff is in the middle on this issue. Staff believes that initially incentives for consolidation should be limited to small (D and E class) companies but could be expanded later if the incentives are deemed successful.

The most common (and contentious) incentive discussed has been the use of an acquisition adjustment. Staff and the industry recommend the development of a policy/rule delineating exactly what type of acquisition adjustment the Commission will allow.

Staff believes that conditions for approval of an acquisition adjustment should include, but not be limited to, situations where:

1. The acquisition is in the public interest.
2. The acquisition will not negatively affect the viability of the acquirer.
3. The acquired system's customers will receive improved service in a reasonable timeframe.
4. The purchase price is fair and reasonable (even though that price may be more than the original cost less depreciation book value) and conducted through an arms' length negotiation
5. The recovery period for the acquisition adjustment should be for a specific minimum time (e.g., twenty years).

The industry representatives on the Task Force advocated the adoption of the California Public Utilities Commission's (CPUC) policy on acquisition adjustments. The California Legislature enacted SB 1268 January 1, 1998, which calls for the rate base of an acquired water utility to be based on fair market value. If fair market value is at or below replacement cost new minus depreciation the CPUC will definitely use fair market value to determine the rate base of the acquired water company. If the fair market value of an acquired utility is greater than replacement cost new minus depreciation the CPUC will base rate base on fair market value only if the following conditions are met: 1) The acquisition will improve the reliability of the water system. 2) The acquisition will improve the acquired company's ability to conform to health and safety regulations. 3) The acquisition will result in significant economies of scale. 4) The acquisitions effect on existing customers is fair and reasonable. If these conditions are not met, or if the CPUC determines that the acquisition is not in the public interest, the CPUC can deny the acquisition altogether. To date the CPUC has received only two applications for treatment under SB 1268, one for the merger of two A class utilities and one for the

purchase of a B class. The CPUC has not issued a decision on either application as of September 27, 1999.

All members of the Task Force agreed that negative acquisition adjustments should never be imposed. An acquirer of a water company should not be penalized for the acquisition through application of a negative rate base acquisition adjustment. Instances where negative adjustments to rates due to negative acquisition adjustments are not common. However, there may be many opportunities for acquisition of small water systems that could be discouraged if the acquiring company believed that negative acquisition adjustments would affect current rates or return.

RUCO was opposed to any form of an acquisition adjustment. However, RUCO acknowledged that problems do exist with small non-viable water systems in the state and that acquisition by larger well-run utilities is potentially beneficial. RUCO advocated three policies to encourage the acquisition of small non-viable water companies by larger utilities: a surcharge for capital investment and a rate of return premium, and a deferral accounting order.

RUCO (and Staff) Option 1 - Allowance of an incremental premium on the Company's authorized rate of return. In light of the additional risks a purchasing utility takes on when acquiring a non-viable system, an additional rate of return would be authorized by the Commission. This option would create a monetary incentive for the acquisition of non-viable systems, yet unlike an acquisition adjustment, the authority to determine the appropriate level of the incentive would remain with the Commission. If a rate of return premium were approved, it could be limited to a specific length of time (perhaps five years or until the next rate case, whichever is shorter).

RUCO Option 2 - A surcharge mechanism that would allow the acquiring company to obtain up front ratepayer funding of the capital investment necessary to make the acquired system viable. Since there is a lag between a company's outlay of cash for capital investments and the recognition of the investment in rates, this creates disincentives for acquisition of non-viable companies. This disincentive can be removed by creating a regulatory mechanism that would allow the estimated cost of the necessary improvements to be included in a rate surcharge and funded up front by ratepayers. Once the improvements were completed, the cost estimated would be trued up to actual.

RUCO Option 3 - A deferral accounting order that would allow the acquiring utility to defer for future rate recovery extraordinary repair and maintenance costs necessary to improve the quality of service of the non-viable acquisition. The amount ultimately recoverable would be determined in the context of a rate case.

Commission Staff believes that a rate of return premium should be considered with the same conditions as acquisition adjustments above. Staff does not recommend approving both a rate of return premium and recovery of an acquisition adjustment for the same company for the same purpose. Staff recommends that one or the other be chosen in each case that is applicable.

PROS AND CONS: ACQUISITION ADJUSTMENTS

PROS: Acquisition adjustments are an effective incentive for consolidation.

CONS: RUCO provides the following reasons for opposing acquisition adjustments:

1) An acquisition adjustment would allow buyers and sellers of utility property to dictate the magnitude of the incentive through the buying and selling price. The higher the selling price, the greater the windfall profits to both buyer and seller, with captive ratepayers footing the bill.

2) Staff has developed a proposed set of criteria a utility would have to meet to qualify for an acquisition premium. While this criteria may ultimately be effective in preventing some of the dangers of allowing acquisition premiums, from a practical stand point it would entail additional regulatory oversight, analysis, and create further demands on utilities as well as regulatory agencies. This is in conflict with the task force's stated goal of shorting and streamlining the regulatory process. This is an important point to keep in mind in examining any of the regulatory reforms proposed by the various parties to the task force. It is important that the vehicles and mechanisms we consider in our goal of regulatory reform don't further complicate and encumber an already burdensome process.

The industry counters RUCO's first claim: The water industry is facing unprecedented capital demands to deal with growth, water supply and water quality. The shortage is *capital to invest* not *projects to invest in*. What rational buyer would pay even \$1.00 more than necessary to purchase a water company? The buyer would have no difficulty investing the amount of RUCO's inflated purchase price in actual water facilities that would provide hard assets and solve actual problems. RUCO's claims that a buyer would benefit and presumably realize "windfall profits" by inflating rate base are without merit. Limiting the California fair market value approach to only non-affiliated buyers and sellers would eliminate any incentive for collusion.

PROS AND CONS: RATE OF RETURN PREMIUMS

PROS: Would create a monetary incentive for the acquisition of non-viable systems.

CONS: None identified.

PROS AND CONS: SURCHARGE MECHANISM

PROS: Eliminates the lag between a company's outlay of cash for capital investments and the recognition of the investment in rates, which creates disincentives for acquisition of non-viable companies.

CONS: None Identified.

PROS AND CONS: DEFERRAL ACCOUNTING ORDER

PROS: Allow the acquiring utility to defer for future rate recovery extraordinary repair and maintenance costs necessary to improve the quality of service of the non-viable acquisition.

CONS: None identified (this issue was not addressed by any of the Task Force members other than RUCO).

2. Strengthen the financial capacity of the water utility industry.

PROPERTY TAX

One of the most contentious issues in many rate cases is that of the appropriate allowance for property taxes. Staff has two recommendations with regard to this issue:

1. Work with and/or lobby the legislature (and if necessary the Counties) to eliminate property taxes for water companies. If this could not be accomplished, then,
2. Staff should develop a policy/rule that would allow for a "Property Tax Adjustment Mechanism". This would work in the same fashion as a fuel adjuster mechanism.

The industry recommends that the existing manner of determining and paying water utility property taxes be replaced with a percentage of revenue tax that would be paid monthly to the Department of Revenue (DOR). Revenue is already a key variable in the formula used by the DOR to determine each water utility company's full cash value. The replacement tax would be an add-on to the customers' water utility bills. The tax collected could be reported and paid to DOR as part of the sales tax return. Industry is willing to help develop detailed recommendations and an implementation plan.

PROS AND CONS: PROPERTY TAX CHANGES

PROS: Changes in the current property tax policies could significantly enhance the industries financial capacity.

CONS: The legislature and/or counties may not be receptive to our ideas.

The industry pointed out other problems associated with property taxes and ratemaking and recommends that the Commission's current policy on these issues be reevaluated.

The industry believes that problems result because in Arizona, property taxes are based on beginning-of-the-calendar-year balances of plant accounts, with the resulting payment made in two equal installments—one in November and the other in May of the following year. To the extent a utility has filed a rate case using a calendar 1998 test year and December 31, 1998 rate base, and the case is being heard during May of 1999, the most recent tax bill that would have been received is that which reflects plant balances one year earlier than the end of the test year. No property taxes associated with 1998 plant additions would be provided for in new service rates. In that situation, the utility's actual property taxes prospectively will likely exceed those recovered in rates.

The industry believes that another factor leading to potential under-recovery of property tax expense under current Commission ratemaking practices is the fact that water utilities' property valuations include an element reflecting operating revenues during the tax year. Any adjustments to test year revenues (i.e., annualization to end-of period customer levels) and any authorized rate increase will ultimately cause property taxes to increase. In computing the gross revenue conversion factors necessary to convert earnings deficiencies into increases in annual revenues, it is just as important to consider the effect of additional revenues on property taxes as has traditionally been done with respect to revenue taxes, income taxes and unbilled revenues. The propriety of such

inclusion was recently recognized by the Arizona Court of Appeals who recently remanded to the Commission a rate order for Turner Ranches Water Company that failed to consider the effect of revenues in the determination of property tax valuations.

AUTOMATIC RATE CHANGES

Commission Staff proposes that all "C", "D" and "E" size water companies should be allowed to automatically (without filing a rate case with the Commission) increase the commodity portion of their rates each year by five percent (5%) or the amount of the increase of the Consumer Price Index (CPI) or perhaps the Producer Price Index (PPI) in Arizona, whichever is *less*. This increase would take effect May 1 of each year. However, in order to qualify to do this, a company must meet all of the following requirements:

1. Submit a request for such an increase by February 15 of the year in which the increase is to take effect.
2. Notice all its customers of the request no later than the date the request is filed with the Commission (a standard notice should be developed by Staff).
3. The request must be accompanied by a letter from the Arizona Department of Environmental Quality (ADEQ) stating, "ABC Water Company is delivering water that has no maximum contaminant level violations and meets the quality standards of the Safe Drinking Water Act."
4. The request must be accompanied by a letter from the Arizona Department of Revenue stating, "ABC Water Company is current on its sales tax obligations."
5. The request must be accompanied by a letter from the appropriate county stating, "ABC Water Company is current on its property tax obligations."
6. The request must be accompanied by a fully completed Water Use Data Sheet.
7. For the first time such an increase is requested, the company's present rates must have been approved in a full rate case that used a test year that is no more than three years prior to the year the automatic increase is to take effect.
8. Once such an increase is implemented, the company must file a full rate case at least every five years or five years from its last rate case, whichever is sooner.
9. The company must have had no formal complaints filed against it in which the Commission ruled against the company within the three years prior to the year in which the automatic increase is to take effect.

Staff believes that it is desirable to require companies using this program to file rate cases at least every five years for two reasons. First, it will insure that the automatic rate changes do not allow the company to consistently over-earn. Second, many small companies wait excessive amounts of time between rate cases, some as long as twenty years. This can be very problematic when rate cases are filed.

The Commission Staff would prepare a recommended order for Commission decision no later than April 30 of each year. The order would either deny or approve the increase. The order could contain conditions such as, but not limited to:

1. File a full rate case in less than five years,
2. Install certain plant within a given timeframe,

If a request were filed and not ruled on by the Commission by April 30, the increase would take effect as an interim/refundable rate. If the Commission later denied the increase, the rates would be decreased. The decrease would reduce the rates by twice as much as the increase and would be in effect for as long as the increase was in effect. After this time the rates would return to their original amount. Example:

- the original rate was \$3.00 per thousand
- the increase made the rate \$3.15 per thousand
- the company had the \$3.15 rate for May, June and July before the Commission issued an order stating that the rate increase was inappropriate and should be refunded

- The rate would be decreased to \$2.85 per thousand for the months of August, September and October

- In November the rates would return to \$3.00 per thousand

The industry supports Staff's proposal indicating it is a worthwhile concept. However the industry believes that the exclusion of "A" and "B" companies, the qualifying requirements and the annual two and one half-month timetable are arbitrary and likely to be unworkable. The industry is willing to help develop more detailed recommendations and an implementation plan.

RUCO believes that Staff's proposal to allow Class C, D & E utilities to raise their rates based on a CPI inflation factor is highly biased against ratepayers and will result in annual rate increases without a finding of fair value. Staff's proposal would assume generic across-the-board expense increases, and would ignore the very real fact that costs also decrease. It would also allow utilities to raise rates without examining the mitigating offsets such as customer growth, consumption growth, and depreciation of the rate base.

PROS AND CONS: AUTOMATIC RATE CHANGES

PROS: Provides a mechanism for small water utilities to deal with increases in their costs. Would provide an incentive for small utilities to file rate cases in a more timely manner.

CONS: Would allow utilities to raise rates without examining the mitigating offsets such as customer growth, consumption growth, and depreciation of the rate base.

FUTURE TEST YEAR

Currently, rate base for Arizona's water companies is calculated using an "historic test year." A recent 12 month period is chosen to be the "test year" and the expenses and capital in place during that year are used as the basis for setting rates. The industry favors a "future test year" policy. Under such a policy rate applications can include specific, highly scrutinized planning for capital expenditures and operating expenses that can be predicted with a high degree of certainty in both cost and timing. A rate adjustment applicant can provide a capital expenditure that details the degree of investment and the timing of it over future months and years. Rate adjustments can be granted from the perspective of a contract being entered into between the applicant and the Commission. Prospective rate adjustments can be conditioned on the amount of investment and the actual occurrence of expenditure. In the event capital expenditures for improvements to water systems are not made pursuant to the capital expenditure program filed as part of a

rate application, the previously granted rates would not become effective. The completion milestones of accomplished capital projects are sufficiently easy to measure to ensure delivery of actual benefit to the customer. The industry is not opposed to the adoption of prospective test years for rate applications with reasonable qualifications and conditions including punitive operational and economic consequences if a utility fails to make projected investments that were included in its forecasted test year rate base (without mitigating circumstances) for rate applicants that did not achieve the scheduled results.

According to the National Association of Regulatory Utility Commissioners ("NARUC"), the Commissions of approximately thirty (30) states permit the use of prospective test years for rate applications¹.

RUCO is opposed to adopting a future test year policy. They feel that there are numerous problems with its use. These include the setting of rates based on estimates that are not known and measurable, inclusion of plant in rates that is not used and useful, and violations of the matching concept when certain rate elements are projected or estimated and others are not. An historical test year inherently matches revenues, expenses, and investment, and contains known and measurable data. RUCO believes that the numerous problems and biases that result from the use of projected data far outweigh any potential benefit that could be derived from abandoning a historical test year.

Commission Staff is in the middle on this issue. Staff believes the Commission is currently using a very reasonable combination of historical and future test years. However, Staff recommends developing a policy/rule for allowing pro forma adjustments for future plant additions that met very specific requirements, such as, but not limited to:

1. Revenue-neutral plant, i.e., will serve existing customers and not future growth.
2. The plant will be installed within a specific time frame, preferably within one year.
3. The plant is necessary to provide proper and adequate service to existing customers.

NOTE: Although the above suggestions are highly likely to save time, effort and money for the water companies and their rate payers, most will require additional Commission Staff to process, analyze and monitor (particularly monitor to insure adherence with all the required conditions) in a timely manner.

PROS AND CONS: FUTURE TEST YEAR

PROS: A future test year policy may encourage necessary capital expenditure by Arizona's water companies. This is because such a policy would result in a reduction of the "regulatory lag" often associated with recovery of such expenses.

CONS: Rate setting will involve estimates of future costs that are unauditable at the time rates are set. Will place additional burdens on Commission Staff resources.

GENERIC HOOK-UP FEES

¹ 17th Annual Western Utility Rate School, April 1997, San Diego, California.

Commission Staff has recommended and the Commission has approved Off-site Facilities Hook-up Fees for a handful of water companies in the past. The process that was used required both water companies and Staff to expend a substantial amount of time and effort. Staff recommends developing a generic hook-up fee policy/rule that would allow water companies to collect from new customers a portion of the cost of new wells and storage tanks that will have to be installed in the future. As in the past, any plant that was installed using hook-up fees would be considered contributed plant.

The reason for having the hook-up fee pay for only part of the new plant is to insure that the company retains a balance between contributed plant and its own investment.

The industry supports Staff's proposal while recognizing that many details need to be worked out. The industry emphasizes that generic approaches should not be mandatory in all cases, case specific facts and circumstances should always be considered. The industry is willing to help develop detail recommendations and an implementation plan.

RUCO agrees that working toward a recognized methodology for the use of hook-up fees is a desirable objective. However, comments from the water task force members on this issue were limited and more discussion on this topic is needed.

PROS AND CONS: GENERIC HOOK UP FEES

PROS: 1) Will free up time and resources currently expended on individual hook-up fee applications

2) Will establish a consistent rule or policy for all water utilities

CONS: The details of this plan need to be worked out, care must be used to ensure that the specific details of the generic hook-up fees do not create any undesirable or unanticipated impacts.

PLANT REPLACEMENT FUND

One of the most significant problems facing the Water Industry today is the required re-building of the existing infrastructure as it approaches the end of its useful service life. Based on a recent survey by the Environmental Protection Agency, it is presently forecasted that such investment needs nationwide during the next twenty years approaches \$140 billion, of which nearly \$80 billion relates to transmission and distribution system replacement. While substantial federal and state funding is available, it is clear that such amounts represent only a portion of the overall financing needs. Utilities and the customers served thereby will be called upon to provide the remainder.

The industry indicates that under current regulatory policies and practices, utilities must first obtain or provide the necessary amounts to fund construction projects and see them to completion before seeking rate recovery. This is consistent with the traditional "used and useful" ratemaking standard which prohibits charging current customers for the costs of capital assets not yet devoted to the provision of service. Once the assets are

deemed to be used and useful, there begins a period for rate setting which generally delays the commencement of capital cost recovery. The problem is exacerbated due to the fact that so many of the projects are ongoing and short in duration. The industry feels that this subjects many utilities to a game of constant catch-up. Given the tremendous projected capital requirements for future infrastructure replacement, the industry (and Staff) believes that the need for a new regulatory tool is clear.

Staff recommends that a policy/rule be developed whereby water companies would be allowed to collect in rates money that would be placed in a separate interest bearing account that could be used only to replace aging infrastructure or major plant that experienced a catastrophic failure. The fund would be established during a rate case and contributions to the fund would be in excess of the revenue necessary for the company to earn its approved rate of return.

All water systems will eventually need to have equipment replaced. Staff believes that establishing a fund for such replacement would assist in insuring that the customers receive quality service and that the company is not caught by surprise in having to replace major portions of plant. This fund should not be allowed to be used for normal annual expenses that should be taken care of in ordinary rates, but should only be used for extraordinary expenditures for replacement of infrastructure due either to age or emergency. Staff believes that another customer protection that should be instituted for the plant replacement fund is that any plant installed with these monies could be considered a contribution. Staff recognizes that the tax implications of a plant replacement fund need to be carefully considered when or if the details of this policy are worked out.

In addition, Staff believes that if a company does receive approval for a plant replacement fund, consideration should be given to reducing the rate of return the company is allowed to earn. The reason for this is that Staff believes that such a fund should substantially reduce the risk a company is incurring. The industry does not agree with Staff on this issue.

The industry advocates adoption of a similar policy: the Pennsylvania Public Utility Commission's (PPUC) Distribution Service Investment Charge (DSIC). The DSIC is a surcharge that allows Pennsylvania water utilities to recover the costs of specific types of revenue-neutral capital investments. A key expected benefit of the DSIC is that it will enable utilities to accelerate infrastructure replacements, since such projects will be more affordable for both the utilities and their ratepayers. Other potential benefits include greater rate stability and lower rate case filing expenses.

Under the DSIC program, at the end of each quarter utilities identify the original cost of eligible distribution system improvements placed in service during that period, net of accrued depreciation. These amounts are then used to compute a surcharge reflecting the associated depreciation expense and a return on investment. The return on investment is based on actual capital structure and debt, preferred equity costs as of the end of the calculation period, and the cost of equity approved in the company's last general rate case. Such information must be filed with the PPUC Staff and Pennsylvania's Consumer Advocate at least ten days prior to the effective date of the surcharge.

Only the following investments are covered by the DSIC:

- Services, meters, and hydrants installed as in-kind replacements.
- Mains and valves installed as replacements for worn out facilities or as upgrades to meet PPUC requirements.
- Main extensions installed to eliminate dead ends and to implement solutions to regional water supply and/or health problems.
- Main cleaning and relining.
- Funds needed to relocate facilities necessitated by highway construction.

The PPUC's DSIC policy includes the following provisions to ensure that ratepayers are protected:

- The DSIC surcharge is limited to 5% of the customer's total bill.
- Utilities using the DSIC surcharge are audited annually. Over collections resulting from the surcharge are refunded with interest and under collections are billed in future rates without interest recovery.
- The surcharge is set to zero when new base rates are calculated.
- The surcharge is set to zero if it is determined that the company is over earning.
- Investments covered by the surcharge reflect used and useful plant placed into service during the three-month period prior to the surcharge's effective date.
- Customers must be notified about any changes in the surcharge.

Currently five Pennsylvania water companies are using the DSIC surcharge. These five companies serve over 50% of Pennsylvania's private water customers. The staff of the PPUC regards the DSIC system as a success. A number of other states have since begun considering the introduction of such a mechanism. Most recently, the Illinois legislature passed a bill designed to give the Illinois Commerce Commission the requisite authority to introduce such a mechanism in that State. Arizona Commission Staff is not opposed to a policy similar to Pennsylvania's DSIC.

RUCO agrees that such a mechanism, if properly designed, has the potential to promote the upgrading of deteriorating water systems, without harmful or biased rate impacts on customers.

Commission Staff is not opposed to implementing a policy similar to Pennsylvania's DSIC. However, Staff is concerned that such a policy may overwhelm the Commission's resources if several companies apply at one time. If this is deemed to be a real problem, Staff believes that the DSIC policy should be modified to mitigate this potential problem.

PROS AND CONS: PLANT REPLACEMENT FUND

PROS: Would help facilitate the upgrading of aging water systems and if designed after the Pennsylvania mechanism, would not allow utilities to recover investment prior to their being used and useful.

CONS: 1) The DSIC policy may strain Commission Staff resources.

2) (RUCO) Would allow the utility to mitigate regulatory lag that is unfavorable to the utility, but would not mitigate regulatory lag that is unfavorable to ratepayers. Potential matching/bias problem *if not properly designed*.

DEPRECIATION

In the mid 80's the Commission attempted to increase water companies cash flow to a level that would cover their established cash expenses and debt service requirements. Depreciation rates were doubled for small water utilities, increasing from approximately 2.5% to 5%. This increased cash flow but created other long term problems. Specifically, funds received through the artificially high book depreciation rates were not available to be reinvested in plant; they were required to meet cash expenses and debt service. Also, the high book depreciation rates resulted in net utility plant being exhausted (zero rate base value) at a time when the physical facilities had 20 to 30 years of additional life. (Most water plant has a 40 to 50 year life, under the 5% depreciation rate its economic value is gone at 20 years.)

The effects of the Commission's past depreciation policy will extend over the next 20 to 30 years. Once utility plant is fully depreciated, providing adequate earnings and cash flow becomes very challenging. Since rate base is zero or perhaps even negative the traditional ratemaking formula doesn't produce any authorized net operating income and allowances for depreciation expense are no longer available. Without net operating income or a depreciation allowance there is no source of funds for plant investment.

Today's Staff recognizes the error of a 5% depreciation rate and is recommending changing to a more realistic rate during general rate proceedings, however the industry believes that additional changes are necessary to address the problem over the remainder of this utility plant cycle. Such changes could include increases in allowed rates of return to compensate for the early exhaustion of net utility plant; pro forma staff rate case adjustments to net utility plant:

(1) to eliminate depreciation allowances that were not recovered through the rates; (2) to add back an increment of utility plant in rate base computations as if it had been depreciated over its economic life on a straight line basis (recognizing that the Company should have earned a fair return on its investment over the life of the plant; an additional depreciation allowance would not necessarily be provided because the company has already recovered a return of its investment); (3) as the depreciation rate is reduced from 5% to 2% or 2.5% during a rate proceeding replace the lost cash flow with a rate of return adjustment, i.e. a 3% or 2.5% return increment respectively on gross utility plant; (4) authorize an Operating and Maintenance Reserve that would be funded by an annual charge equal to 1% to 5% of utility plant. The charge would be deposited in a restricted interest bearing account that could only be used for operations or maintenance expense items not included in the authorized rates, for example major pump repair, tank painting, etc.

Commission Staff and RUCO are opposed to the industry's proposals. Both Staff and RUCO believe that the industry's proposals constitute retroactive ratemaking and would result in double payment by consumers.

Staff recognizes the problems that the industry points out but Staff believes these problems can be solved through a much simpler policy. Since when rate base is zero or negligible the traditional ratemaking formula doesn't produce any authorized net operating income, Staff believes that the traditional ratemaking formula should be abandoned for companies with near zero rate bases. Rates for such companies could be set on an operating margin basis. Plant replacements could then be handled with a mechanism similar to the Pennsylvania DSIC or plant replacement fund discussed above.

Setting rates on an operating margin basis involves determining the companies operating costs and setting rates that cover those costs plus a percentage, or "margin," that can be used for reinvesting in plant or other purposes.

PROS AND CONS: INDUSTRY RECOMMENDATION FOR CORRECTING PAST EXCESSIVE DEPRECIATION RATES.

PROS: Would provide small water companies with needed capital.

CONS: Would result in retroactive ratemaking and double recovery.

PROS AND CONS: COMMISSION STAFF RECOMMENDATION FOR CORRECTING PAST EXCESSIVE DEPRECIATION RATES.

PROS: Would provide small water companies with needed capital. Would not be complicated.

CONS: May not be appropriate for all utilities.

3. Provide greater emphasis on simplifying, shortening, and reducing the cost of the ratemaking process.

PASS THROUGH MECHANISM (SB1252)

In 1997, the Arizona Legislature passed Senate Bill 1252. This bill was enacted to create the statutory basis for the Arizona Corporation Commission to implement a mechanism under which regulated water utilities may be afforded an opportunity to reflect in rates the effects of changes in specific costs without the necessity and expense of filing a general rate case. The operating costs that may be considered in this procedure are limited to specific, readily identifiable costs that are subject to the control of another person, including the cost of purchasing electricity or gas, the cost of purchasing water from another utility or municipality, and the payment of proper taxes or similar taxes and assessments that may be levied on the utility.

Thus far only one utility has applied to the Commission for authority to adjust rates under the provisions on this mechanism. There are a number of reasons that have been cited for the lack of utilization, including ambiguities in the language of the statute and concerns about the symmetry that would exist between rate increases and rate decreases. However, according to the industry, the common understanding is that the Staff's proposed surcharge rules presented to the Water Utilities Association at their annual meeting were unreasonable. Staff proposed that a company that filed for and received a postage surcharge, for example, would have to file sur-refunds not limited to decreases in postage cost but including decreases in ANY of the other cost elements eligible for surcharge treatment. This would be required even though the Company had not been passing on increases in these other cost elements.

Current policy lacks the support of a prior decision, policy statement, rule or any official position of the Commission. The industry believes that clarity of the intent and application of S.B. 1252 is needed before its usage will achieve the objectives of its promoters and supporters. The industry recommends that the Commission clarify their policy on surcharge applications and limit increases or decreases to the specific operating cost included in each companies approved surcharge(s). This matter might also be explored to determine what changes (i.e., legislative, procedural, etc.) might be made that would foster expanded use of the mechanism.

RUCO is opposed to the industry's proposal. They feel that the proposal is extremely biased against consumers since, with the industry proposal, cost increases will be past on to consumers but cost decreases will be ignored.

PROS AND CONS: INDUSTRY PROPOSAL FOR SB 1252

PROS: Would allow companies to recover increases in costs that were outside of their control.

CONS: Will allow utilities to raise rates outside of a rate case for those costs that have increased yet would not recognize cost decreases. Biased against ratepayers.

RATE OF RETURN

Many members of the Task Force suggested that one way of shortening the rate case process was to develop a generic rate of return that would apply to all water companies. Staff does not believe that this would be workable in many cases that come before this Commission because so many of the companies have very little rate base with which to work. However, Staff would recommend developing a policy/rule that would allow a water company to choose which method it preferred for Staff to compute its revenue requirement. The three choices could be:

1. Generic rate of return. The Cost of Capital Group within the Accounting & Rates Section could develop a rate of return appropriate for Arizona water companies on an annual, semi-annual or other appropriate timeframe. This rate of return would then be applied to each individual company's rate base.

2. Operating Margin. This would apply to those companies not having a large enough rate base to allow for a meaningful rate of return.

3. Individual Rate of Return. This would allow a company to go through the typical rate of return case and not use the generic rate of return if the company believed the generic return did not apply to it.

The Industry supports Staff's proposal and is willing to help develop a more detailed plan.

RUCO supports Staff's proposal with one caveat: they feel that a generic rate of return would be inappropriate for large (class A and B) utilities since the rate of return for larger utilities is a highly material item and is dependant on more than the current economic and financial environment. The individual characteristics of a utility effect rate of return (i.e. capital structure).

PROS AND CONS: STAFF PROPOSAL ON RATE OF RETURN SIMPLIFICATION

PROS: Rate of return is typically a resource intensive portion of a rate case, and predetermining the rate would certainly simplify and shorten this portion of a rate case.

CONS: May not be appropriate for all utilities.

ELECTRONIC FILING

The industry and Staff recommend developing an electronic filing procedure that could be used by any water company with a computer (this would be for all filings with the Commission, i.e., rate cases, financing cases, annual reports, etc.). The current filing process could be significantly enhanced by creating a library of standard reporting forms on computer disks that could be copied for use by affected companies.

This process should include exact copies of the electronic spreadsheets used by Staff in the assessment and analysis of rate applicants' filings. Many major regulatory agencies such as the Federal Energy Regulatory Commission, Federal Communications Commission, and the Securities and Exchange Commission, already allow companies subject to their jurisdiction to file annual reports via electronic means. The Commission has talked about just such a thing in the past. The largest impediment in accomplishing this goal has been resources – both in manpower and funds. Once the resources are available, Staff recommends proceeding with this item as a high priority.

RUCO supports the Staff and industry position.

PROS AND CONS: ELECTRONIC FILING.

PROS: Would simplify and reduce the cost of rate filings.

CONS: Implementation would require significant resources.

The industry is concerned about the volume and extent of informational and other filing requirements imposed by the Commission. Some of the requirements originated many years ago when circumstances were quite different from today, and prior to the introduction of sophisticated computer tools that are now at our disposal. Therefore, the industry recommends that a determination be made with respect to the continuing need for and value of the quantity and variety of information presently required to be filed with the Commission. This would encompass an assessment of the current rate case filing requirements, required annual report contents, and the level of detail that water utilities are obligated to include in other types of filings.

Staff believes that such an assessment should be made at the time the Commission implements an electronic filing plan.

MAIN EXTENSION AGREEMENTS (MXAS)

Commission Staff, the industry, and RUCO agree that a new Main Extension Agreement (MXA) rule would be beneficial. The industry and RUCO support the proposal from the Commission Staff that recommends establishing a new MXA rule that requires that each water company submit an MXA tariff detailing exactly the company's MXA procedure. Once the Commission approved that tariff the company would simply have to adhere to that tariff and thus not require Staff to review and approve each and every single MXA. In order for the MXA tariff to remain in effect, the company would have to submit, by each February 1, a letter from (ADEQ) stating, "ABC Water Company is delivering water that has no maximum contaminant level violations and meets the quality standards of the Safe Drinking Water Act."

In addition, Staff recommends changing the present refund mechanism to allow water companies to enter into MXAs that would refund portions of the actual monies collected (the amount actually paid for the plant) and not just a portion of the revenue collected. This would allow water companies to collect a fair share of main extension costs from all customers connecting to a main and not just from the first connection, i.e., customers connecting after should not be allowed to have a "free ride".

PROS AND CONS: TARIFFED MAIN EXTENSION AGREEMENTS

PROS: Will eliminate the redundancy of approval of each individual agreement a utility enters into with developers and customers.

CONS: As with other regulatory reform proposals, care will need to be taken to ensure that the final rule on MXAs will not create any new regulatory problems or have any unanticipated adverse impacts on customers.

4. Improve Consumer Education.

Both industry and consumer members of the Task Force acknowledge the need for greater consumer education. Many consumers are unfamiliar with the basics of the regulatory process and therefore are reluctant to intervene in cases that directly effect them. Industry and consumer members of the Task Force recommend that RUCO be encouraged to produce a publication (or publications) explaining basic issues in the water utility industry such as:

1. How the rate case process works.
2. What rate base is and how it is calculated.
3. How to read a balance sheet and income statement.
4. How to form a water users association.
5. How to intervene in Commission proceedings.
6. Basic negotiation skills.

These publications should be placed on the Commission's web site, or a separate web site, in order to facilitate maximum public exposure.

RUCO also suggested that public meetings be held throughout the state. The purpose of these meetings would be to educate consumers regarding the different state agencies that deal with utilities and each agency's specific role. The meeting would also present information regarding the various options open to consumers when they have complaints/ concerns regarding their utility company. Meetings would be announced via advertising in local newspapers.

The only impediment to implementing the above policies is the availability of funds. Both the Commission and RUCO would likely require additional appropriations for these projects.

The Task Force members also recognize that operators of many small water companies may lack the necessary regulatory knowledge to file effective rate cases. Industry members of the Task Force felt that workshops conducted by the Commission Staff were very effective in educating water company operators in rural areas. The Task Force strongly encourages Staff to continue these workshops. Staff has indicated that these workshops are currently underway.

Industry members of the Task Force also recommend that the COMMISSION encourage, on a voluntary basis, water companies to distribute educational publications to their customers. These publications could include company newsletters, Customer Service Reference Guides, and/or publications from organizations such as the American Water Works Association.

Many small water companies do not have the resources to produce quality educational publications. Staff recommends that large water companies that are currently producing high quality educational publications make those publications available to smaller water companies to use as models.

PROS AND CONS: CUSTOMER/INDUSTRY EDUCATION

PROS: Would be of direct benefit to both customers and the industry.

CONS: The proposals would require additional appropriations for the Commission and for RUCO.

5. Other Issues**PHASE IN OF RATES**

Commission Staff recommends the adoption of a rate phase-in policy. Under such a policy rate increases that were considered to be "large" could be phased in over time. This could avoid "rate shock" and thus allow water companies to come in for rate cases on a less frequent basis, thereby saving the company and its customers rate case expense and the Staff time and effort. Staff believes that under such a policy rates could still be set that allowed the company full recovery of its authorized rate of return.

Staff recommends developing a policy/rule that would define what a large rate increase is, based not only on a percentage increase, but also on the actual rates. For example, an increase from a \$5.00 minimum and \$0.50 per thousand gallons to a \$10.00 minimum and \$1.00 per thousand would be a 100% increase. The question is whether this is a large enough rate increase to require a phasing in of the new rates or were the original rates so low that a 100% increase in this case would not be unfair to the customers, but anything less would be unfair to the company.

Staff sees rate phase-ins as a means to deal with special circumstances, not as a general policy for all rate cases. Staff believes that phase-in rates can be very helpful in dealing with (for example) situations where small water systems are making very large investments in their infrastructure. This was the case in Decision Number 61275 (docketed in December of 1998) where the Commission approved a rate phase-in plan for Alpine Water System, Inc.

The industry opposes this idea. They feel that such a policy could result in the deferral of the full amount of the revenue requirement until a later date. If so, phase-in of rates could damage the financial capacity of the industry.

PROS AND CONS: PHASE-IN OF RATES

PROS: Could alleviate "rate shock."

CONS: Could result in under-recovery for water companies.

RATES TIED TO CONDITIONS

Commission Staff proposes that all rate increases should be conditioned on the company providing acceptable quality service, installation of plant, repair of plant, water quality, etc. Therefore, Staff recommends that a policy/rule be developed to outline what the conditions would be and what the consequences are if the water company does not meet those conditions. The industry and RUCO did not comment on this proposal.

PROS AND CONS: RATES TIED TO CONDITIONS

PROS: Would make necessary rate increases more acceptable to consumers, while holding companies responsible.

CONS: May result in additional work for Staff and companies.

III. CONSERVATION SUBCOMMITTEE

The Conservation Subcommittee of the Commission's Water Task Force mainly focused on coordination between the Commission and the Arizona Department of Water Resources (ADWR.)

BACKGROUND ON ADWR POLICY:

In order to insure adequate conservation of ground water, the ADWR *requires* large private water companies within active management areas (AMAs) to meet certain gallons per capita per day (GPCD) requirements. The GPCD requirements vary across companies based on the geographic location of the company and other factors. The ADWR evaluates companies based solely on whether they meet their GPCD requirements. Companies are free to use whatever conservation measures they deem appropriate to meet the GPCD requirements. Generally, the ADWR does not force companies to use any specific conservation measures, although the ADWR assumes that water providers will implement one or more conservation measures in order to comply with the GPCD requirement. Only *after* a company consistently fails to meet its GPCD requirement will the ADWR issue a Consent Decree that forces the company to adopt a specified conservation program. It should be stressed that complying with the ADWR's GPCD requirement is not discretionary by private water companies (within AMAs); although the choice of which conservation measure to implement is up to the private water company.

PERCEIVED PROBLEM

Industry, consumer, and ADWR representatives on the Task Force indicated that a problem exists because a company that expends funds on conservation programs in order to meet the ADWR's GPCD requirement may not be able to recover fully those expenditures through rates. This is because conservation expenditures may not meet the Commission's "used and useful" standard. The Commission may disallow the conservation expenditures because they were not specifically mandated by the ADWR. However, Commission Staff indicates that this has never happened in practice. Due to this uncertainty and the uncertainty that compliance can be achieved by the implementation of the conservation measures, companies may be reluctant to invest in conservation programs.

The industry recognizes another problem that was not openly discussed, as part of the Task Force. That problem is the regulation of private water companies by two state agencies, namely ADWR and the ACC. The regulations from both agencies are sometimes in conflict, as can be seen concerning water conservation – ADWR requires conservation and the ACC requires that the private water company furnish water on demand to all customers, even if it would cause a private water company to exceed its GPCD limit.

PROPOSED SOLUTION:

The Conservation Subcommittee of the Commission's Water Task Force recommends a program whereby companies can voluntarily seek approval of their conservation programs from the ADWR prior to their application to the Commission for the recovery of conservation costs. Under the program the company will present its conservation program to the ADWR. The ADWR will examine the conservation program and will determine the following: 1) is a conservation program necessary in order for the company to meet its GPCD requirement? 2) Will the company's conservation program allow the company to meet its GPCD requirement? 3) Is the conservation plan reasonably efficient? That is, is there no other potential conservation plan that would allow the company to meet its GPCD requirement at a significantly lower cost?

If the ADWR determines that the answers to all three of the above questions are yes, the company can file a written statement of that determination with its rate application to the Commission. Commission Staff proposes that the Commission should strongly consider the ADWR's determinations concerning the conservation plan when processing the companies rate application.

The industry and ADWR believe that the Commission should do more than strongly consider the ADWR's determination. They recommend that if the ADWR has made such a determination then the Commission should automatically allow for the recovery of conservation costs. They believe that Staff's proposal does not mitigate the uncertainty associated with conservation expenditures. Industry believes that if the ADWR can determine the effectiveness of the conservation measures and the ACC determines the cost-effectiveness of the conservation measure, the ACC should allow full cost recovery.

Staff is opposed to the industry/ADWR proposal because Staff believes that the Commission should have final say on cost and rate determinations. The Staff believes that companies may "gold plate" their conservation programs and then attempt to pass on unreasonable costs to their customers, although this has generally not been the case with private water companies. During meetings of the conservation subcommittee the ADWR indicated that they were not prepared to make determinations on the reasonableness of company costs, since auditing is not their specialty.

This process could be used by a water company that is applying for rates through a traditional rate case or, potentially, through ARS 40-370. Although some members of the conservation subcommittee are of the opinion that ARS-370, which allows for the pass through of costs outside of a water companies control, should apply to costs associated with meeting the ADWR's GPCD requirements, Staff does not concur.

PROS AND CONS: STAFF'S CONSERVATION COST PROPOSAL

PROS: Would (in Staff's opinion) mitigate some of the uncertainty involved in recovery of conservation cost.

CONS: Would (in industry/ADWR's opinion) not mitigate any of the uncertainty involved in recovery of conservation cost nor (in industry's opinion) would it guarantee compliance with the ADWR's GPCD requirement.

PROS AND CONS: INDUSTRY/ADWR'S CONSERVATION COST PROPOSAL

PROS: Would mitigate some of the uncertainty involved in recovery of conservation cost, although (in industry's opinion) it would not guarantee compliance with the ADWR's GPCD requirement.

CONS: Would put final say over the appropriateness of costs with the ADWR, which has little expertise with auditing.

RATE DESIGN

Commission Staff believes that, in order to promote conservation, the rate design for all water companies should incorporate at least a three-tiered inverted rate structure. Staff believes that inverted rates will promote some conservation. All parties agree that, regardless of where a company is located in this State, the Commission should be encouraging conservation. Staff believes that the primary mechanism that the Commission has for such promotion is rate design. In addition, with providing a three-tiered rate design, those people that truly conserve, will save money. Customers that use very little water each month will have a very small water bill. Staff believes that it is desirable that customers should be rewarded for conserving.

Staff's proposal is as follows: At the time of a rate case, two gallonage per month limits (lower and upper) and three rate tiers should be established (bottom, middle, and high.) Customers whose consumption is below the lower gallonage limit will be charged the bottom tier rate, those with consumption between the two limits will be charged the middle tier rate, and customers with consumption above the upper limit will be charged the highest tier rate.

The bottom tier would be less than break-even, the middle tier would provide the desired rate of return, and the highest tier would provide more than the approved rate of return. By setting rates in this manner the Commission would likely be providing the company with revenues in excess of those necessary to generate its approved rate of return. To remedy this over-earning (a company should not be allowed to over-earn, without some very hard, strong and definite strings attached), the company could be required to put 75% of all monies generated by the third tier rates, or 90% of all over-earnings, into a separate interest bearing account. Why only put a percentage of the third tier rates or a percentage of all over-earnings into the separate account? The two primary reasons are:

- a. There is some cost for producing this water. The company should be allowed to recover this cost.
- b. There is the possibility that with such a rate design there could be a significant amount of conservation. If this is the case, there is a possibility that the company could be prevented from earning its allowed rate of return.

The money from this account could be used:

1. To pay penalties to the Arizona Department of Water Resources for not meeting conservation goals,
2. To pay for conservation programs,
3. To pay for CAP water (if used and useful),
4. To pay for the installation of new water production facilities (wells or surface water treatment plants) and/or storage tanks that would be considered as contributed plant,
5. To build up a plant replacement fund, with plant paid for by these monies considered as contributed plant,
6. Any other Staff recommended expenditure.

The above expenditures could not be made without Commission approval and would be audited on a regular basis. The monies collected from the third tier or over-earnings that were set aside in the interest bearing account could not be used for normal everyday expenses, nor operation and maintenance expenses, nor salaries and wages of any type, etc. In addition, the company would be required to file a full rate case at least once every five years.

Staff believes that it is unlikely that the above policy will result in under-earnings for the company. However, if under-earnings do occur, Staff believes that the company should have recourse to recover the "lost" revenues. Also, Staff stresses that this is not a "cookie cutter" approach to rate design. The rate tiers and gallonage limits would be determined on a company by company basis while taking the particular circumstances of the company into account.

The industry is strongly opposed to Staff's three tiered rate proposal. They believe that the proposal could result in significant under-earnings.

RUCO is also strongly opposed to Staff's three tiered rate proposal. They believe that the proposal, "fail(s) to capture the essence, purpose, importance, and complexity of rate design; (is) unsound and (un)supportable; and generate(s) a plethora of inequities, new problems, and unanswered questions." They are concerned that the proposal could result in significant over-earnings and they point out that there is no guarantee that the proposal will actually result in increased conservation.

PROS AND CONS: STAFF'S THREE TIERED RATE STRUCTURE

PROS: Could provide the Commission with a mechanism to promote conservation.

CONS: May result in over/under-earnings. There is no guarantee that the proposal will actually promote conservation. Would add another layer of complexity to water utility reporting and accounting. Would not guarantee compliance with the ADWR's GPCD limitation. Could penalize large families who are using water in compliance with GPCD limitations. May provide disincentives for commercial/industrial development in those areas with tiered pricing. May not adequately consider the facts specific to any one water provider and would arbitrarily impose three-tiered pricing on the private water company.

IV. WATER SUPPLY SUBCOMMITTEE

The Water Supply Subcommittee's (WSS) primary focus was the planning for long term water supplies, such as those provided by the Central Arizona Project (CAP), and how to recover their costs in such a way that is fair and equitable to both the water companies and their customers. The recovery of CAP costs was the single biggest problem that the WSS identified. CAP cost recovery is problematic because companies with CAP allocations must pay for their CAP water whether they use it or not. Such companies are reluctant to give up their allocations because, even though they are not used currently, they may be needed in the future. There were many differing views expressed in the WSS, such as, allowing the recovery of CAP costs just because they are incurred to not allowing them at all until there is actually CAP water flowing through the pipes of a company. Staff proposes that the Commission adopt a combination or compromise position.

Commission Staff proposes that CAP costs should be recoverable on an interim basis once a company has submitted to the Commission, and the Commission has approved, a plan to actually use CAP water. The company must commit to using the CAP water within five years of the approval of the plan, with no time extensions allowed. The recovery would be on an interim basis because if the company did not implement the plan within the five-year time frame, it would be required to refund the monies collected back to its customers.

The recovery of CAP costs would be part of permanent rates and could be set up as an adjuster once the CAP water is actually used by the company. The reason for setting up these costs as an adjuster is because history has shown that these costs are anything but stable. The prices being paid by water companies today for CAP water are much higher than ever projected in the 1980s. Staff believes that these recommendations on handling CAP costs will further promote the use of CAP water. The industry believes that this method of handling costs may force the water industry to use more CAP water than is necessary before it is fully needed or in the event that certain factors prevent the full use of a water provider's CAP allocation, the loss of CAP water supplies could result.

Many members of the WSS believed that a standardized application for approval of cost recovery plans should be developed. The standardized application would include the technical information necessary for the Commission to make an informed decision. A standardized application would remove some uncertainty for companies and customers. The WSS members have started the development of such a standardized application.

Many times the water industry has stated that the Commission and its policies were at direct odds to the groundwater conservation policies of Arizona. Staff disagrees with any such assertion. Staff believes that the Commission has been one of the few, if not the only State agency that has promoted the *actual use* of CAP water. Simply holding on to and paying for a CAP allocation does nothing to conserve groundwater.

However, Committee Members agree that the loss of CAP water, such as when a private water company can no longer afford to pay the holding costs of CAP, would be detrimental to the private water company's customers. The only way to conserve and/or preserve groundwater is to use less of it or replace it (e.g., through the recharge of CAP water). Using CAP water is one of the primary ways to use less groundwater. The Commission has always had a policy of allowing the recovery of CAP costs once CAP water was used. Staff believes that continuing this policy with the modification suggested above will further encourage the use of CAP water and not just simply the holding of it.

The WSS agreed that cost recovery for long term water supplies could be accomplished outside of a rate case in most instances. However, if the company is small enough or the costs associated with long term water supply are large enough to significantly change the companies entire cost structure, the Staff believes that a rate case is necessary.

The ADWR and the Industry believes that Staff's proposal is a positive step. However, they feel that the proposal does not go far enough towards ensuring the recovery of CAP costs. The ADWR believes that Staff's proposal should guarantee the recovery of the cost of the companies entire CAP allocation regardless of how much of the allocation is used within the first five years. They also point out that while the ADWR would clearly prefer to see the use of CAP water replace mined groundwater as early as possible, this may not always be practical within the five year period. Also, the capital charge component of the CAP water, while significant, is minor in comparison to infrastructure costs associated with full CAP utilization.

As an alternative to Staff's proposal, the ADWR proposes that capital charges for the entire allocation be recoverable immediately if the company develops a plan which demonstrates that: 1) demand projections for the next 20 years equal or exceed the CAP allocation; 2) a portion of the allocation, determined on a case by case basis between ADWR, the Commission and the company, will be used within the first five years either through direct delivery or by recharging the water in a location which contributes to groundwater availability in the area of the provider's wells; and 3) the use of CAP will increase over a period of time (to be determined in each case) up to the extent of the allocation.

The ADWR also proposes that once a provider has exhausted its CAP supplies (i.e. they are being fully utilized), groundwater use that is replenished by the Central Arizona Ground Water Replenishing District (CAGRDR) should be handled similarly. For example, to the extent that a regulatory structure is established for member lands which provides for replenishment in an area where the provider's wells will pump the water, CAGRDR assessments should be fully recoverable. Such a structure was established for member service areas in last year's legislative session at the urging of Scottsdale and other providers. A similar proposal for member lands may be considered in this next session. The Industry believes that the ADWR's proposal for CAGRDR membership and associated assessments may be necessary for some private water companies, especially where physical availability has been identified as a problem. Cost recovery in these instances should be allowed by the ACC. Membership in the CAGRDR may also provide a mechanism for new growth to occur or to resolve conservation requirements.

RUCO is opposed to both Staff's and the ADWR's proposals. RUCO believes that the recovery of the cost of CAP allocations should not be allowed until the allocation is actually being used. They contend that it is speculative and hypothetical to project what a company *may* do with CAP water over the next 5 years. RUCO has stressed the idea that the used and useful principle of ratemaking rules out proposals such as Staff's and the ADWR's. According to RUCO, the used and useful principle cost recovery can only be allowed for water that is actually being used at the time the company applies for recovery.

RUCO stresses that companies do not need to be actually delivering CAP water to their customers in order for the CAP allocation to be considered used and useful. Alternative usage arrangements such as groundwater replenishment, water exchange agreements, etc. are acceptable to RUCO. RUCO has recently supported CAP cost recovery for three companies with such alternative usage plans: Paradise Valley Water Company rate case (Decision No. 61831), Citizens Utilities' Sun City Water Company, and the Sun City West Utilities Company. RUCO proposes that companies seeking recovery of costs associated with unused CAP allocations should be encouraged to actively seek such alternative usage arrangements.

The industry opposes RUCO's water supply recommendations. They believe that RUCO's comments reflect a single-minded focus on rate minimization rather than open-minded consideration of various alternatives and do not reflect support for long range planning. Long range planning must extend well beyond a 5-year planning horizon. Each AMA has a slightly different goal and each water provider has unique water needs.

PROS AND CONS: STAFF PROPOSAL ON CAP COST RECOVERY

PROS: Would allow recovery of costs while encouraging companies to actually use their allocations.

CONS: Cost recovery would be based on projections of future activity over five years. The Industry believes that the proposal could force water providers to use more CAP water than is needed within five years and in the event that a water provider could not put CAP water to use within 5 years could force the water provider to relinquish its CAP allocation.

PROS AND CONS: ADWR PROPOSAL ON CAP COST RECOVERY

PROS: Would allow recovery of costs while providing some encouragement for companies to actually use their allocations. Allows for longer-range water planning than either the Staff or RUCO's proposals.

CONS: Cost recovery would be based on projections of future activity over twenty years.

PROS AND CONS: RUCO PROPOSAL ON CAP COST RECOVERY

PROS: Would encourage the actual use of CAP water.

CONS: May not allow for cost recovery for companies that are making a good faith effort to put their CAP allocation to use in the near future.

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Appendix: Comments of individual members

COMMENTS FROM THE INDUSTRY REPRESENTATIVES OF THE WATER TASK FORCE

Submitted August 17, 1999

I. REGULATORY REFORM GOAL:

STRENGTHEN THE FINANCIAL CAPABILITY OF THE WATER UTILITY INDUSTRY

1. Distribution infrastructure replacement cost recovery mechanism.

One of the most significant problems facing the Water Industry today is the required rebuilding of the existing infrastructure as it approaches the end of its useful service life. Based on a recent survey by the Environmental Protection Agency, it is presently forecasted that such investment needs nationwide during the next twenty years approaches \$140 billion, of which nearly \$80 billion relates to transmission and distribution system replacement. While substantial federal and state funding is available, it is clear that such amounts represent only a portion of the overall financing needs. Utilities and the customers served thereby will be called upon to provide the remainder.

Under regulatory policies and practices existing in most states, utilities must first obtain or provide the necessary amounts to fund construction projects and see them to completion before seeking rate recovery. This is consistent with traditional "used and useful" ratemaking standard which prohibits charging current customers for the costs of capital assets not yet devoted to the provision of service. Once the assets are deemed to be used and useful, there begins a period for rate setting which generally delays the commencement of capital cost recovery for months or even years after the assets begin to serve customers. The problem is exacerbated due to the fact that so many of the projects are ongoing and short in duration. For many utilities this is a game of constant catch-up. Given the tremendous projected capital requirements for future infrastructure replacement, the need for a new regulatory tool is clear.

One state facing extensive infrastructure replacement has introduced an innovative approach to cost recovery that eliminates the time and expense associated with the traditional approach to ratemaking. In 1996, the Pennsylvania legislature provided statutory authority for the Public Utility Commission to establish a tariffed automatic adjustment clause mechanism designed to give utilities the ability to periodically adjust rates via the introduction of a surcharge intended to recover the costs associated with infrastructure replacement programs, thereby significantly reducing the traditional regulatory lag. Given the title Distribution System Improvement Charge ("DSIC"), this mechanism considers the costs being incurred in connection with specific types of revenue-neutral projects designed to enhance water quality, fire protection reliability, and long-term system viability. These include: main and valve replacement, main cleaning and relining, fire hydrant replacement, and main extensions to eliminate dead ends. A key expected benefit of the DSIC is that it will enable utilities to accelerate infrastructure remediation, thereby making the projects more affordable for both the utilities and their ratepayers. Other potential benefits include greater rate stability and lower rate case filing expenses.

Under the DSIC program, at the end of each calendar quarter utilities identify the original cost of eligible distribution system improvements placed in service during that period, net of accrued depreciation. Such amounts are then used to compute a surcharge reflecting the associated depreciation expense and a return on investment based on actual capital structure and debt and preferred equity costs as of the end of the calculation period, and cost of equity approved in the respective company's last general rate case. Such information must be filed with the PUC Staff and Consumer Advocate at least ten days prior to the effective date of the surcharge which is typically the first day following the end of the calendar quarter succeeding the measurement period. For example, the surcharge intended to begin recovering the cost of eligible additions during the first calendar quarter in a given year would typically begin on July 1st.

The DSIC mechanism in Pennsylvania is not without significant ratepayer protections built in. They limit the surcharge to 5% of the total customer bill, and provide for annual

reconciliation audits, with over-collections refunded with interest. The surcharge is reset to zero at the time of new base rates or at any time that it is determined the utility is over-earning.

The effect of the DSIC thus far has been overwhelming. A number of other states have since begun considering the introduction of such a mechanism. Most recently, the Illinois legislature passed a bill designed to give the Illinois Commerce Commission the requisite authority to introduce such a mechanism in that State.

The Regulatory Reform Committee of the Water Task Force respectfully requests that the Commission assess the anticipated infrastructure replacement requirements currently facing the water utilities in Arizona in light of existing ratemaking policies and practices, and strongly consider the merits of moving toward the establishment of a mechanism comparable to the Pennsylvania DSIC.

2. Expanded utilization of existing pass-through mechanism.

In 1997, the Arizona Legislature passed Senate Bill 1252. This bill was enacted to create the statutory basis for the Arizona Corporation Commission to implement a mechanism under which regulated water utilities may be afforded an opportunity to reflect in rates the effects of changes in specific costs without the necessity and expense of filing a general rate case. The operating costs that may be considered in this procedure are limited to specific, readily identifiable costs that are subject to the control of another person, including the cost of purchasing electricity or gas, the cost of purchasing water from another utility or municipality, and the payment of proper taxes or similar taxes and assessments that may be levied on the utility.

Although the initial reaction to the passage of this legislation was positive, the anticipated widespread utilization has never materialized. Thus far only one utility has applied to the Commission for authority to adjust rates under the provisions on this mechanism. There are a number of reasons that have been cited for the lack of utilization, including

ambiguities in the language of the statute and concerns about the symmetry that would exist between rate increases and rate decreases. However the common understanding is that the Staff's proposed surcharge rules presented to the Water Utilities Association at their annual meeting were unreasonable. The opposition of a former Commissioner led to Staff implementation proposals that would have required a Company that filled for and received a postage surcharge, for example, to file sur-refunds not limited to decreases in postage cost but including decreases in ANY of the other cost elements eligible for surcharge treatment. This would be required even though the Company had not been passing on increases in these other cost elements. Continuing the postage example, if that same company experienced a decrease in power, purchased water or taxes they would be required to file for a sur-refund.

Generally, the water utility industry believes that Staff has developed implementation guidelines for the approval of applications under a S.B. 1252 filing that do not match the intent or the language of the Bill. Potential applicants become easily discouraged when investigating the usage and possible parameters of S.B. 1252 with Staff. Staff's guidelines lack the support of a prior decision, policy statement, rule or any official position of the Commission. Clarity of the intent and application of S.B. 1252 is sorely needed before its usage will achieve the objectives of its promoters and supporters.

For whatever reasons the surcharge authority of SB 1252 is not being fully utilized. The legislation creating this pass-through mechanism was intended to address uncontrollable cost increases being experienced by water utilities in Arizona and to help strengthen their financial capability. It is recommended that the Commission clarify their policy on surcharge applications and limit increases or decreases to the specific operating cost included in each companies approved surcharge(s) This matter might also be explored to determine what changes (i.e., legislative, procedural, etc.) might be made that would foster expanded use of the mechanism.

3. The damage from existing and previous depreciation practices needs to be recognized when establishing rates for the smaller water companies.

In the mid 80's the Staff attempted to "help" water companies by increasing their cash flow to a level that would at least cover their established cash expenses and debt service requirements even if they were denied a reasonably sufficient operating income. Depreciation rates were doubled for small water utilities, increasing from approximately 2.5% to 5%. This increased cash flow but aggravated the industry's problems.

Funds received through the artificially high book depreciation rates were not available to be reinvested in plant; they were required to meet cash expenses and debt service. The high book depreciation rates would result in net utility plant being exhausted (no rate base value) at a time when the physical facilities had 20 to 30 years of additional life. Most water plant has a 40 to 50 year life, under the 5% depreciation rate its economic value is gone at 20 years. Although today's Staff recognizes the error of a 5% depreciation rate and is recommending changing to a more realistic rate during general rate proceedings, no one has yet addressed the problem over the remainder of this utility plant cycle.

The effects of this policy will extend over the next 20 to 30 years. Once utility plant is fully depreciated, providing adequate earnings and cash flow becomes very challenging. Since rate base is zero or perhaps even negative the traditional ratemaking formula doesn't produce any authorized net operating income. Allowances for depreciation expense are no longer available. Without net operating income or depreciation allowance there is no source of funds for plant investment.

Some water utilities were further penalized because they were unable to earn their authorized rates and operated at a loss over a number of years. During the loss years the companies did not actually recover their 5% depreciation allowance. Nevertheless at rate case time Staff would blindly deduct the entire depreciation allowance whether recovered through the rates or not. Rate setting principles provide that a utility company is entitled to a both a return *on* its investment while it is devoted to serving the public and a return *of* its investment as it is used up. The return *of* investment is a source of funds that is

assumed to be reinvested in utility plant. Unfortunately small water company regulation has not worked this way in Arizona.

How can effect of these misguided depreciation practices be remedied by the current Commission? There is no best single solution. It is encouraging that changes are already taking place to correct the excessive 5% rate, but remedies to address the long term effects are also required. Such remedies could include increases in allowed rates of return to compensate for the early exhaustion of net utility plant; *pro forma* staff rate case adjustments to net utility plant: (1) to eliminate depreciation allowances that were not recovered through the rates; (2) to add back an increment of utility plant in rate base computations as if it had been depreciated over its economic life on a straight line basis (recognizing that the Company should have earned a fair return *on* its investment over the life of the plant; an additional depreciation allowance would not necessarily be provided because the company has already recovered a return *of* its investment); (3) as the depreciation rate is reduced from 5% to 2 % or 2.5% during a rate proceeding replace the lost cash flow with a rate of return adjustment, i.e. a 3% or 2.5% return increment respectively on gross utility plant; (4) authorize an Operating and Maintenance Reserve that would be funded by an annual charge equal to 1% to 5% of utility plant. The charge would be deposited in a restricted interest bearing account that could only be used for operations or maintenance expense items not included in the authorized rates, for example major pump repair, tank painting, etc.

REDUCE THE NUMBER OF SMALL, NON-VIABLE WATER SYSTEMS THROUGH NEW RULES AND PROCEDURES

1. Limit the formation of start-up water utility companies by developers and inexperienced organizers. Do not issue CCN's to newly established start-up water companies until all options to have service provided by an existing viable company have been exhausted. Provide notice to existing companies of the need to serve newly developing areas and solicit statements of interest.

2. Encourage industry consolidation to develop larger and stronger companies with greater managerial, technical and financial capability.

Any consideration of consolidation of the water utility industry in Arizona should not be limited to smaller Class "D" and "E" companies. Larger companies should not be excluded from the benefits of industry consolidation. It is likely that consumers benefit from the economies of scale realized by the combination of merged entities regardless of the individual sizes of acquiring companies.

The California Public Water System Investment and Consolidation Act of 1997 (the "Act") specifically states that "scaled economies are achievable in the operation of public water systems". Further, the Act states that "providing water corporations with an incentive to achieve these scaled economies will provide benefits to ratepayers". The California Act does limit its interpretation or application to the size or viability of water systems. The California legislators and Commission have realized that water sources are finite and fewer numbers of distributors of the product accrues to the benefit of the ratepayer.

For purposes of acquisition adjustments, the California Act generally provides that acquisitions of water companies utilize the fair market value (FMV) approach when considering the value of the water system infrastructure assets. However, the Act further provides that the Commission may also include the difference between FMV and reproduction cost when the value differences are considered "fair and reasonable". The California Commission uses a four level evaluation criteria to determine allowable differences between FMV and reproduction cost as follows: (1) the affect on water system reliability, (2) improvements in compliance of health and safety regulations, (3) the ability to achieve economies of scale that would otherwise not be available but for acquisition, and (4) the fair and equitable affect on current customers. The representatives of the Arizona water utility industry members of the Water Task Force unanimously support the California Act and encourage the Commissioner's consideration of same.

In addition to those provisions of the California Act, the representatives of the water industry on the Water Task Force believe that any policy developed by the Commission which considers incentives to encourage industry consolidation should ensure that an acquirer of a water company should not be penalized for the acquisition through application of a negative rate base acquisition adjustment. Instances where negative adjustments to rates due to negative acquisition adjustments are not as common. However, there are undoubtedly many opportunities for acquisition of smaller water systems by larger, more resourceful companies that could be discouraged if the acquiring company believed that negative acquisition adjustments would affect current rates or return of, or on, investment.

3. Provide special incentives to encourage the takeover of non-viable companies of any size or any Class D or Class E water utility on the presumption that merely because of their size they cannot provide the managerial, technical and financial resources need to comply with the SDWA.

4. Permit Use of Prospective Test Years in Rate Applications:

According to the National Association of Regulatory Utility Commissioners ("NARUC"), the Commissions of approximately thirty (30) states permit the use of prospective test years for rate applications¹. Staff argues that utilization of historical test years in rate applications makes sufficient provisions for the effect of future water system investment through consideration of "known and measurable" expenses. The critical difference in Staff's viewpoint with that of the water industry is a matter of perspective.

Water industry representatives of the Water Task Force believe, as is conducted in many other states without difficulty, that rate applications can include specific, highly scrutinized planning for capital expenditures and operating expenses that can be predicted with a high degree of certainty in both cost and timing. A rate adjustment applicant can provide a capital expenditure that details the degree of investment and the timing of same

¹ 17th Annual Western Utility Rate School, April 1997, San Diego, California.
9 Appendix

over future months and years. Rate adjustments can be granted from the perspective of a contract being entered into between the applicant and the Commission. Prospective rate adjustments can be conditioned on the amount of investment and the actual occurrence of expenditure. In the event capital expenditures for improvements to water systems are not made pursuant to the capital expenditure program filed as part of a rate application, the previously granted rates would not become effective. The completion milestones of accomplished capital projects are sufficiently easy to measure to ensure delivery of actual benefit to the customer.

The "business as usual" perspective of Staff requires expenditure of the capital amounts first and recovery, subject to the usual regulatory delays, thereafter. This policy is discouraging to water system owners and operators in the consideration of needed improvements to the water systems. Water system operators generally know, or can readily determine, what improvements are required in their water systems. The cost associated with such improvements is as easily determinable. The rate adjustment application process is sufficiently resourceful to determine a realistic implementation schedule of water system improvements. The water industry representatives of the Water Task Force believe adoption of a policy of prospective test years would encourage water systems improvements at a rate much more rapid than those presently occurring. The water industry representatives of the Water Task Force would not be opposed to adoption of prospective test years for rate applications with reasonable qualifications and conditions including punitive operational and economic consequences for rate applicants that did not achieve the scheduled results.

**PROVIDE GREATER EMPHASIS OF SIMPLIFYING, SHORTENING
AND REDUCING THE COST OF RATEMAKING
AND REGULATORY COMPLIANCE**

1. Eliminate unnecessary and/or redundant filing requirements and forms, and introduce computerization into the filing process.

Many of the water utilities in Arizona, particularly the smaller ones, are concerned about the volume and extent of informational and other filing requirements imposed by the ACC. Some of the requirements originated many years ago when circumstances were quite different from today, and prior to the introduction of sophisticated computer tools that are now at our disposal. In connection therewith, the Regulatory Reform Committee of the Water Task force recommends that a determination be made with respect to the continuing need for and value of the quantity and variety of information presently required to be filed with the Commission. This would encompass an assessment of the current rate case filing requirements, required annual report contents, and the level of detail that water utilities are obligated to include in other types of filings.

In addition to an evaluation of current filing requirements, it is also recommended that consideration be given to automation of the filing process. In today's business world, even the smallest of companies have access to a personal computer. The current filing process could be significantly enhanced by creating a library of standard reporting forms on computer disks that could be copied for use by affected companies. This process should include exact copies of the electronic spreadsheets used by Staff in the assessment and analysis of rate applicant's filings. This improvement has the potential to significantly reduce the time and cost associated with routine filings with the Commission. In connection therewith, the Commission should also explore the possibility of introducing the option of electronic filing. Many major regulatory agencies such as the Federal Energy Regulatory Commission, Federal Communications Commission, and the Securities and Exchange Commission, already allow companies subject to their jurisdiction to file annual reports via electronic means. The ACC should strongly consider the potential benefits associated with automation of the filing process.

2. Reduction in Regulatory Lag Associated with Rate Decisions:

The water industry representatives of the Water Task Force strongly encourage the Commission and Staff to search for ways in which the affect of regulatory lag may be reduced. At present, many months stretching to more than a year may be required to

determine the appropriateness of rate adjustments. The affect of regulatory is, by itself, a discouragement to water system owners to file rate applications at all. No rule, regulation, or policy should be adopted or passed which does not consider how regulatory lag may be reduced.

II. IMPROVEMENTS IN CONSUMER EDUCATION GOAL:

The water industry representatives of the Water Task Force would like to propose a three-prong approach whereby the Arizona Corporation Commission; the water utility industry and RUCO would take the lead in educating our customers. All three of these groups have the knowledge; experience and manpower to present and communicate with the consumers on many issues which are facing our industry. The following are some of the tasks, which each group can contribute to better educate our customers.

(i) Arizona Corporation Commission (ACC)

- (a) Web site – Although ACC already has a Web Site (<http://www.cc.state.az.us>) in existence, I believe this Web site should be further promoted to the public at large in order for them to learn more about what's happening at the ACC.
- (b) Continue publishing "Water News" on a quarterly basis.
- (c) Continue making visits to each county on an annual basis to discuss issues related to consumers, water utility industry and the local governmental officials.
- (d) Form a Task Force at the county level, which will be in charge to educate and coordinate the issues in the water industry. The Task Force should consist of two representatives from each of the following: ACC, water utility industry, consumer group, and county officials.

(ii) Water Utility Companies

- (a) ADEQ requires that as of October 1, 1999 each water utility company publish a "Consumer Confidence Report" for the previous year. This report will be published on an annual basis and will cover a variety of issues directly related to the operation of that particular water utility company.
- (b) On a volunteer basis, the ACC should encourage water utility companies to publish a company newsletter, a "Customer Service Reference Guide" (see enclosed) or provide the customers with a publication from the American Water Works Association or a similar organization dealing with issues such as conservation, quality of water, quantity of water, etc.

- (c) Encourage water utility companies on a volunteer basis to publish in their local newspaper or to discuss on a local radio/television station local issues related to the water industry.

(iii) RUCO – Encourage RUCO to prepare a publication explaining basic issues in the water utility industry such as:

1. How to read a balance sheet and income statement.
2. Explain what is a rate base.
3. Explain how the rate case is developed.
4. Explain how to form a water user association.
5. Explain how to intervene in an ACC proceeding.

This kind of publication can greatly assist the consumer to understand some very complex issues facing the utility industry.

The water industry believes that better informed customers should expect safe and drinkable water to flow from his household tap. We, in the water utility industry, must insure our customers to receive the highest value to which they are entitled. A well informed customer can help us serve him better.

CONCLUSION

The representatives of the water industry appreciate the opportunity to participate in the ACC's Water Task Force. It is clear that many important issues require attention and resolution. The representatives believe that with proper economic incentives, motivation and opportunity that the natural capabilities of the market place can resolve most or all of these issues. Conversely, decreased and efficient regulation provides a similar benefit that can achieve levels of prosperity and compliance in an industry that is sorely deficient.

WATER TASK FORCE
COMMENTS OF THE RESIDENTIAL UTILITY CONSUMER OFFICE
AUGUST 16, 1999

REGULATORY REFORM SUBCOMMITTEE

**ISSUE NO. 1 - REDUCE THE NUMBER OF SMALL, NON-VIABLE
 WATER SYSTEMS THROUGH NEW RULES AND
 PROCEDURES**

A large number of the state's water utilities are small in size, quite often uneconomical, and experience operational problems that they are often unequipped to handle. A potential solution to some of the small non-viable utility problems is the acquisition by larger, better-run utilities. However, it is apparent that acquisition of small, uneconomical, non-viable water systems will not occur absent some sort of regulatory incentive. Most, if not all, of the Task Force members were in agreement on the need for regulatory reform in this area. Agreement, however, was not reached regarding the appropriate incentives and circumstances under which such incentives would be available.

It is RUCO's position that regulatory incentives for acquisition should be available only in those instances where absent the incentive, the acquisition would not take place. For example, acquisitions of larger well-run utilities by other similar type companies are common place and currently occur without the need for incentives. In such situations incentives are unnecessary and would simply constitute regulatory gifts. Incentives should be available only for small utilities (in general Class D & E) that are determined to be non-viable. The Commission in the context of the acquisition proceeding would determine viability. The acquiring company would bear the burden of demonstrating the non-viability of the acquired company.

RUCO strongly opposes the use of acquisition adjustments as a regulatory incentive to acquisition. We believe a policy that would allow rate recovery of acquisition adjustments (the excess purchase price over net book value) would ultimately allow regulated companies to set their own rates in a monopoly environment. Further, the Commission would have no control over the level of regulatory incentive because the buyer and the seller would be able to set the level of the incentive through the asking and purchasing price. A situation would result where the rate bases of utilities could be inflated by the mere buying and selling of property. Both buyer and seller would realize windfall profits through the inflated purchase price with captive ratepayers funding such windfalls. The Commission has options other than acquisitions adjustments to create incentives for larger utilities to acquire small non-viable systems.

- Option 1 - Allowance of an incremental premium on the Company's authorized rate of return. In light of the additional risks a purchasing utility takes on when acquiring a non-viable system, an additional rate of return would be authorized by the Commission. This option would create a monetary incentive for the acquisition of non-viable systems, yet unlike an acquisition adjustment, the authority to determine the appropriate level of the incentive would remain with the Commission.
- Option 2 - A surcharge mechanism that would allow the acquiring company to obtain upfront ratepayer funding of the capital investment necessary to make the acquired system viable. Since there is a lag between a company's outlay of cash for capital investments and the recognition of the investment in rates, this creates disincentives for acquisition of non-viable companies. This disincentive can be removed by creating a regulatory mechanism that would allow the estimated cost of the necessary improvements to be included in a rate surcharge and funded upfront by ratepayers. Once the improvements were completed, the cost estimated would be trued up to actual.
- Option 3 - A deferral accounting order that would allow the acquiring utility to defer for future rate recovery extraordinary repair and maintenance costs necessary to improve the quality of service of the non-viable acquisition. The amount ultimately recoverable would be determined in the context of a rate case.

ISSUE NO. 2 - STRENGTHEN THE FINANCIAL CAPABILITY OF THE WATER UTILITY INDUSTRY

Although the Task Force did agree this was an issue, it was never discussed in depth. RUCO believes the issue of financial capacity is closely related to the small non-viable water company issue discussed above. The acquisition of these types of systems by larger better-run utilities would, for the most part, address this issue. In addition, RUCO suggests the following:

- 1) Increase the number of small water company workshops conducted by ACC Staff. Expand the scope of the workshops to include information on utility accounting, effective financial planning, capitalization alternatives (i.e. CIAC vs. Equity, AIAC vs. Debt), etc.
- 2) Change AAC Staff policy of using 5% depreciation rates for small utilities. This policy has resulted in negative rate bases for numerous small to medium water companies.

- 3) Encourage water companies to file rate cases in a timely manner. Provide ACC assistance to those small companies that do not have the technical expertise to complete their own rate applications.

ISSUE NO. 3 - SIMPLIFYING, SHORTENING, AND REDUCING THE COST OF THE RATEMAKING PROCESS

The Task Force members all agreed this was an area that could benefit from regulatory reform. Members had differing opinions on how this should be accomplished. RUCO suggests the following:

- 1) Develop a comprehensive set of minimum filing requirements (MFRs) to be required with all rate applications. The MFRs would be designed to supply Staff and RUCO with certain generic accounting data that is necessary in all cases to perform a regulatory review. The MFRs would include such items as the general ledger, year-end closing journal entries, test year billing determinants, monthly operating reports, schedules of plant retirements and additions, etc. This would cut down on the number of initial data requests and also remove the 10 day time constraint the utilities currently operate under.
- 2) Improve communications and cooperation among utilities, Staff, and RUCO during the rate review process. Conversations between the utility and the respective analyst can cut down on discovery by clarifying information needs and constraints. An initial meeting between the utility and the analyst to explain the salient points of the application and to answer questions informally would help narrow the scope of the analyst's review.
- 3) Negotiation and settlement discussions can reduce the number of litigation issues, reduce rate case expense, and result in fair and reasonable results.
- 4) Stricter application of ACC sufficiency requirements. Quite often extensive discovery and audit work is required simply because of calculation errors, data omissions, incorrect billing determinants, etc. included in a utility's application. Quite often these problems are not resolved at the discovery stage and then require additional resources to litigate. These types of problems should be resolved before the rate application is found sufficient.

ISSUE NO. 5 - IMPROVE CUSTOMER EDUCATION

Although there was very little discussion by the Task Force on customer education, all agreed it was an issue. From phone calls that RUCO receives from the utility customers it is apparent that the average customer is uninformed as to the state agencies that deal with utilities, the regulatory process, and their individual participation options in the process. RUCO suggests the following:

- 1) Schedule public meetings at various locations throughout the state. The purpose of these meetings would be to educate consumers regarding the different state agencies that deal with utilities and each agency's specific role. The meeting would also present information regarding the various options open to consumers when they have complaints/ concerns regarding their utility company. Meetings would be announced via advertising in local newspapers.
- 2) Develop and distribute statewide a newsletter that contains the information identified in item no. 1 above.
- 3) Develop a web site that includes the above information. Place advertisements statewide regarding location of web site.

While RUCO supports all of the above suggestions we recognize that all will require expending additional resources beyond what is currently included in state regulatory agencies' budgets. Additional appropriations would probably be required.

ISSUE NO. 5 - INCREASE INTERAGENCY COORDINATION

While most of the utility Task Force members agreed that this was a significant issue, RUCO, and to some extent Staff, did not perceive the same problems. Staff argued that many of the specific coordination efforts the utilities indicated they would like to see were already in effect. From a practical standpoint RUCO recognizes that the objectives, mandates, and goals of the individual state agencies that deal with utilities are different and therefore complete coordination is not realistic. RUCO also pointed out that while the ACC can change its way of doing business, it has no control over, for example, ADEQ, DWR, or RUCO. While the goal of interagency coordination is desirable, RUCO believes the other four issues identified by the Task Force are within the control of the ACC and therefore are more obtainable.

WATER SUPPLY SUBCOMMITTEE

The Residential Utility Consumer Office ("RUCO") offers its comments regarding Central Arizona Project ("CAP") cost recovery for water utilities.

RUCO acknowledges and supports the State of Arizona's water policy goals, namely to protect Arizona's groundwater supplies. RUCO believes that this policy is important and should be considered when determining whether water utilities under the jurisdiction of the Arizona Corporation Commission should receive cost recovery for CAP water.

However, each utility is unique and its request for recovery of CAP expenses must be based on its individual history. RUCO's position is that prior to cost recovery being considered, each utility must be using the CAP water (the used and useful ratemaking principle). Although comments were requested on a five year plan, RUCO's position is that it is speculative and hypothetical to project what a company may do with CAP water over the next 5 years. Many intervening events may occur and ratepayers may be paying for water that the utility has never used and ratepayers have never received. Before ratepayers should be asked to pay for CAP water, actual CAP water should be flowing through the companies' pipes and used by their customers or some other CAP usage alternative such as groundwater replenishment, water exchange agreements, etc. should be in place and effective.

Additionally, RUCO offers this comment in regard to the February 10, 1999, letter which sets forth a consensus agreement regarding CAP long term planning expenses. RUCO did not agree that expenses from CAP long term planning should be specifically noted as an expense for which a water utility should seek cost recovery. However, RUCO did not oppose that water utilities may apply to the Commission for cost recovery of CAP expenses outside of a rate case.

**ARIZONA DEPARTMENT OF WATER
RESOURCES**

Office of Assured and Adequate Water Supply
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JANE DEE HULL
Governor

RITA P. PEARSON
Director

MEMORANDUM

To: Matthew Rowell
Arizona Corporation Commission

From: Steve Rossi
Department of Water Resources

Date: August 12, 1999

Re: Comments on Draft Report

At the last Water Task Force Meeting, the group agreed to another round of comments on the draft report prepared by commission staff. The following are the Department's comments regarding the water supply portion of that report.

The proposal by ACC staff is to allow recovery of costs today if the CAP allocation is to be used within five years. The provider must refund the fees if the water is not used. In general, the concept of setting some guidelines that providers must follow in exchange for greater certainty regarding the recovery of CAP costs is a positive step. However, as I pointed out in prior comments, there is a need for additional depth and some changes to these guidelines before they can be considered workable.

There is a presumption (though it is unclear in the report) that a provider is eligible for recovery of only that which is used in the five year period. Thus, if a provider is able to use only half of the allocation in this period (whether the demand exists for the full amount or not), only half of the costs are recoverable. The problem with this approach is that it fails to place any value to current and future customers on that portion of the CAP allocation not used within the five year period. To deny recovery of the costs because the water may not be needed for five or more years is counterproductive to sound long-term water supply planning principles.

While the Department would clearly prefer to see the use of CAP replace mined groundwater supplies as early as possible, we recognize that in this may not always be practical within the five year period. The capitals charge component of the CAP water, while significant, is minor in comparison to infrastructure costs associated with full CAP utilization.

As an alternative, we propose that capital charges for the entire allocation be recoverable immediately if the provider develops a plan which demonstrates that: 1) demand projections for the next 20 years equal or exceed the CAP allocation; 2) a portion of the allocation, determined on a case by case basis between ADWR, ACC and the provider, will be used within the first five years either through direct delivery or by recharging the water in a location which contributes to

groundwater availability in the area of the provider's wells; and 3) the use of CAP will increase over a period of time (to be determined in each case) up to the extent of the allocation.

In addition, once a provider has exhausted its CAP supplies (i.e. they are being fully utilized), groundwater use, which is replenished by the CAGRD, should be handled similarly. For example, to the extent that a regulatory structure is established for member lands which provides for replenishment in an area where the provider's wells will pump the water, CAGRD assessments should be fully recoverable. Such a structure was established for member service areas in last year's legislative session at the urging of Scottsdale and other providers. A similar proposal for member lands may be considered in this next session.

Please contact me if you would like to discuss these comments further prior to our next meeting.

**AWC's Industry Rebuttal Response To Recommendations Submitted
To The WUTF
Submitted September 20, 1999**

On August 25, 1999 a Special Open Meeting of the Arizona Corporation Commission was scheduled to discuss comments submitted for the Task Force's report and to set a due date for rebuttal comments. September 17, 1999 was the date set for submission of rebuttal comments to Matthew Rowell, the Commission's Task Force Chairman.

Comments were presented at the Special Open Meeting from:

- Department of Water Resources (DWR)
- R. W. Trimble
- Residential Utility Consumer Office (RUCO)
- Industry Representatives (Industry)
- Arizona Corporation Commission Staff (Staff)

Arizona Water Company is providing the following industry rebuttal comments to the commentary and recommendations of DWR and RUCU. It reiterates the Industry's June 29, 1999 comments on the Staff' Report recommendations as part of this response.

**DEPARTMENT OF WATER RESOURCES
Industry supports the DWR recommendations**

Recovery of Cap Costs - DWR disagreed with the Staff recommendation and stated that to deny recovery of CAP costs because the water may not be needed for five or more years is counterproductive to sound long-term water supply planning principles.

Industry supports DWR's recommendation that capital charges for the entire allocation be recoverable immediately if the provider develops a plan which demonstrates that: 1) demand projections for the next 20 years equal or exceed the Cap allocation; 2) a portion of the allocation, determined on a case by case basis between DWR, ACC and the provider, will be used within the first five years either through direct delivery or by recharging the water in a location which contributes to ground water availability in the area of the provider's wells; and 3) the use of CAP will increase over a period of time (to be determined in each case) up to the extent of the allocation.

Industry also agrees that CAGR assessments should be fully recoverable.

Recovery Of Conservation Costs - Industry agrees that the Staff recommendations do not address the need for greater certainty regarding the recovery of conservation costs; i.e. a safe harbor for recovery of conservation costs. DWR correctly points out that the Staff's recommendation results in a "business as usual" approach. It provides a several new layers of bureaucratic approval and tests but no greater certainty. As DWR said: "This situation is not acceptable". The Commissioners need to endorse the concept of

regulatory safe harbors for cost recovery and direct the Staff to develop policies in that framework.

RESIDENTIAL UTILITY CONSUMER OFFICE

1. Reduce The Number Of Small, Non-Viable Water Systems Through New Rules And Procedures.

RUCO recognizes the problem: *"A large number of the state's water utilities are small in size, quite often uneconomical, and experience operational problems that they are often unequipped to handle."* However, RUCO's short-term focus on rate minimization for residential customers confines the scope of its analysis and recommendations to a limited, sub-optimal change in Commission policy. .

RUCO is unable to acknowledge even the potential benefit of water industry consolidation in Arizona. Instead they argue that if a variant of the California fair market value approach to encouraging consolidation throughout the water utility industry was adopted in Arizona:

"...the rate bases of utilities could be inflated by the mere buying and selling of property. Both buyer and seller would realize windfall profits through the inflated purchase price."

Although this was a legitimate concern earlier this century when giant holding companies were able to manipulate their portfolios, it is ludicrous in Arizona today. The water industry is facing unprecedented capital demands to deal with growth, water supply and water quality. The shortage is *capital to invest* not *projects to invest in*. What rational buyer would pay even \$1.00 more than necessary to purchase a water company? The buyer would have no difficulty investing the amount of RUCO's inflated purchase price in actual water facilities that would provide hard assets and solve actual problems. RUCO's claims that a buyer would benefit and presumably realize "windfall profits" by inflating rate base are without merit. Limiting the California fair market value approach to only non-affiliated buyers and sellers would eliminate any incentive for collusion.

The California Public Water System Investment and Consolidation Act of 1997 (the "Act") specifically states that "scaled economies are achievable in the operation of public water systems". Further, the Act states that "providing water corporations with an incentive to achieve these scaled economies will provide benefits to ratepayers". The California Act does *not* limit its interpretation or application to the size or viability of water systems. The California legislators and Commission have realized that water sources are finite and fewer numbers of distributors of the product accrues to the benefit of the ratepayer.

Consolidation of the industry based on fair market values would encourage larger and stronger companies with greater managerial, technical and financial capability.

2. Strengthen The Financial Capability Of The Water Utility Industry

"RUCO believes the issue of financial capacity is closely related to the small non-viable water company issue discussed above. The acquisition of these types of systems by larger better-run utilities would, for the most part address this issue." Doesn't this support the goal of broad industry consolidation?

RUCO's three recommendations are acceptable but are unlikely to have the desired impact. They are very limited and conservative. A broader range of initiatives should be employed to deal with this problem; e.g.

- Distribution infrastructure replacement cost recovery mechanism.
- Expanded utilization of existing pass-through mechanism.

1. Provide Greater Emphasis Of Simplifying, Shortening And Reducing The Cost Of Ratemaking And Regulatory Compliance

The first and last of RUCO's four recommendations would complicate, lengthen and increase the cost of ratemaking for the water industry, they should be rejected outright.

- RUCO's first recommendation would significantly expand the content of the existing Standard Filing Requirements to include extensive supporting and backup data such as: 1) The company's entire general ledger
 - 2) Year-end closing journal entries
 - 3) Test year billing determinants
 - 4) Monthly operating reports
 - 5) Schedules of plant retirements and additions
 - 6) Et cetera
- RUCO's fourth recommendation advocates stricter application of the Commission's sufficiency requirements so that Staff would be required to dissect each application looking for calculation errors, data omissions, incorrect billing determinants, etc. This recommendation shifts a portion of RUCO's work to the Staff and is directly at odds with the goal it purports to support.

WATER SUPPLY SUBCOMMITTEE

RUCO's water supply recommendations are off point. They reject the Staff's 5 year time period and are at odds with the second consensus goal of strengthening the financial capability of the water utility industry. They reflect a single-minded focus on rate minimization rather than open-minded consideration of various alternatives.

ARIZONA CORPORATION COMMISSION STAFF

Industry Supports Many Of the Staff Recommendations In Principle

Staff reorganized its earlier recommendations under the five consensus goals adopted by the Regulatory Reform Subcommittee, Water Supply and Conservation. Industry generally supports the thrust of this recommendation but not all of the details as explained in the earlier Industry Response to the Staff Report which is reproduced below. This commentary refers to pages in the earlier Staff report.

1. Rate of Return (page 3)

- Minimal discussion of this topic
- Supports Goal # 3.
- Industry agrees with concept and willing to help develop implementation plan in a manner to also support Goal # 2

2. Phase in Rates (pages 3-4)

- Not discussed. Unclear what Staff is recommending.
- Undermines Goals # 2 and # 3 - Appears that a "large" rate increase might trigger only a limited or partial rate increase at the time the Decision was issued and result in the deferral of the full amount of the revenue requirement until a later date. If this is what the Staff is recommending it could further damage the financial capacity of the water utility industry, while lengthening and complicating the rate making process.
- Industry opposes this concept and any recommendations that further weakens the financial capacity of the industry or lengthens the ratemaking process.

3. Property Tax (page 4)

- Minimal discussion.
- Supports Goals #2 and # 3
- Industry favors a change. Although not previously discussed, the industry recommends that the existing manner of determining and paying water utility property taxes be replaced with a percentage of revenue tax that would be paid monthly to the Department of Revenue (DOR). Revenue is already a key variable in the formula used by the DOR to determine each water utility company's full cash value. The replacement tax would be an add-on to the customers' water utility bills. The tax collected could be reported and paid to DOR as part of the sales tax return. Industry is willing to help develop detail recommendations and implementation plan.

4. Electronic Filing (page 4)

- Minimal but adequate discussion.
 - Supports Goal # 3
 - Industry supports a voluntary electronic filing program and recommends that the Commission develop electronic templates and instructions that would be available from the ACC web site.
5. **4Rate Design** (pages 4-5)
- Never discussed.
 - Undermines Goals # 2 and # 3
 - Industry strongly disagrees with a mandatory three-tier rate structure and the confiscation of utility revenue.
6. **Automatic Rate Increases** (pages 6-7)
- Never discussed.
 - Supports Goal # 2 and # 3
 - Worthwhile concept but exclusion of "A" and "B" companies, qualifying requirements and annual two and one half month timetable are arbitrary and likely unworkable. Industry willing to help develop detail recommendations and implementation plan.
7. **Rates Tied to Conditions** (page 7)
- Never discussed.
 - Not aimed at any of the RRS goals.
8. **Future Test Year** (page 7)
- Minimal discussion of industry recommendation. Staff's opinion is: "...that the present test year method is adequate, workable and accurate." The remaining question is: Does the present test year method produce desired results? Changing the existing method would be one way to improve the financial capability of the industry.
 - Supports Goal # 2
 - Industry willing to help develop detail recommendations and implementation plan.
9. **Generic Hook-Up Fees** (page 8)
- Minimal discussion
 - Supports Goal # 2
 - Industry willing to help develop detail recommendations and implementation plan.
10. **Certificates Of Convenience & Necessity – CC&N** (pages 8-11)
- Extensive discussion
 - Supports Goal #1
 - Industry supports most of Staff's recommendations and is willing to help develop detail recommendations and implementation plan.

11. Main Extension Agreements (page 11)

- Adequate discussion
- Supports Goal # 3
- Industry supports most of Staff's recommendations and willing to help develop detail recommendations and implementation plan.

12. Incentives For Consolidation (pages 11-13)

- Most thoroughly discussed recommendation.
- Supports Goal #1 and can support # 2
- Staff is unable to accept the idea that there are economic benefits to industry consolidation and that it should be encouraged. Staff takes a narrow view, that consolidation incentives should be limited to acquisitions of the "D" and "E" class water companies for now. The industry strongly believes that encouraging consolidation of all classes of water companies would provide economies of scale, strengthen the financial capability of the consolidated companies and reduce the regulatory burden on the Commission.
- The California Legislature and the California Public Utility Commission are encouraging industry consolidation under Senate Bill 1268 The California Public Water System Investment and Consolidation Act of 1997. That legislation states:
 - "Scale economies are achievable in the operation of public water systems."
 - "Providing water corporations with an incentive to achieve these scale economies will provide benefits to ratepayers."

13. Plant Replacement Fund (pages 13-15)

- Limited discussion
- Supports Goal # 2
- Industry agrees with Pennsylvania approach but Staff recommendations to treat plant as a contribution nullifies the concept. Lowering the rate of return for a company with a PRF could cost the company more than it gained.
- Industry is willing to help develop detail recommendations and implementation plan along lines of Pennsylvania program.

14. Education (pages 15-16)

- Discussion of subcommittee work limited by time.
- Supports Goal # 4
- Industry supports.

**WATER TASK FORCE
REBUTTAL COMMENTS OF THE RESIDENTIAL UTILITY
CONSUMER OFFICE
September 16, 1999**

REGULATORY REFORM SUBCOMMITTEE

On August 16, 1999 the Water Industry, Commission Staff, and RUCO submitted individual reports to the Task Force setting forth their respective positions on the five issues previously agreed upon by the all members of the Task Force. The purpose of this document is to respond to the various parties' positions.

**ISSUE NO. 1 - REDUCE THE NUMBER OF SMALL, NON-VIABLE
 WATER SYSTEMS THROUGH NEW RULES AND
 PROCEDURES**

Industry and Staff proposal -

Limit the number of new water companies by refusing to grant CC&Ns to new start-up water companies

RUCO position on the concept -

Task force members have suggested establishing more stringent standards for the issuance of a CC&N as one method for achieving the agreed upon goal of reducing the number of non-viable water systems. RUCO believes establishing new criteria for issuance of a CC&N is one feasible and likely method for reducing the number of non-viable water systems. However, before going forward with a recommendation to establish new CC&N standards, the task force should identify at least one new general or specific area where establishing a new standard will provide an overall benefit. Members of the task force have provided some thought provoking suggestions for improvement. However, in RUCO's view, these suggestions have generated more questions than answers and will not necessarily result in an overall benefit.

PRO - 1) Would prevent an increase in the number of water companies

CON - 1) One proposed plan requires a new water company applying for a CC&N to show that no existing water company will serve the requested service territory as a condition for obtaining a CC&N. Under this plan a new CC&N applicant must show rejection letters from all three "Class A" companies, at least five "Class B" companies, and all existing water companies within five miles of the service territory requested as one condition for obtaining a CC&N. This proposal creates a hierarchy of preferential treatment for

various existing companies. An existing company will not necessarily make a more-fit public service provider than a new company. A small or newly formed water company is not necessarily non-viable or unfit to provide public utility service. Not all small or newly formed water companies have been shown to be unfit. Many large water companies began as smaller entities. It is dubious that any pre-determined distance can be established that will represent the distance from which another water company can effectively service any new service territory. Providing preferential treatment in the CC&N issuance process may be unlawful or present other legal problems.

2) This plan is unworkable. Large, existing water companies may not be interested in expansion. Company's that are not interested in new service territories may be reluctant to assert that disinterest in a rejection letter. Also, new applicants could seek rejection letters only from those "Class B" companies that always reject proposals for new service territories. This would circumvent the intent of requiring a new CC&N applicant to obtain rejection letters from at least five "Class B" water companies as one of the criteria for obtaining a CC&N.

3) This plan also suggests using only the water company's projected customer growth estimates in setting rates to achieve break-even operating results no later than the third year of operation and for earning the authorized rate of return in the fifth year of operation. RUCO believes that other parties (e.g., RUCO, Staff, Hearing Officers, Commissioners, developers, prospective customers, and others) may have valuable input into the growth projections. RUCO does not support this condition because it has the affect of forfeiting RUCO's statutory rights and shirking RUCO's obligation to residential ratepayers to intervene in proceedings that affect rates. Adoption of this condition would lessen the leverage of other parties to encourage proper sizing and economic design of backbone plant and fails to take into consideration other relevant factors such as the number of potential customers. Also, implementing this condition would neither ensure nor even necessarily improve the likelihood that the target third and fifth year operating results would be achieved.

4) Another suggested condition for issuance of a CC&N is that the recipient be in complete compliance with Arizona Department of Environmental Quality (ADEQ) requirements. Complete compliance with ADEQ requirement is a desirable goal. However, it may be preferable to establish a lesser standard that allows some latitude. For example, a water company in complete compliance

could acquire a company in non-compliance resulting in a circumstance that the acquiring company is no longer in compliance and, accordingly, not eligible for the new CC&N. In this instance, the proposed condition provides an undesirable result. Also, a large company with many systems is statistically more likely to have a violation than a smaller company. The proposed condition, therefore, discriminates against large companies and is counter-productive in the effort to reduce the number of small, non-viable companies. RUCO is also concerned that this condition would place ADEQ in an unduly powerful position whereby ADEQ would have a greater influence than the Commission in selecting the companies that operate in new service territories. A more constructive method/model for classifying non-compliance items and eliminating unfit water companies from consideration as new CC&N applicants is needed.

5) Staff has suggested that standard fees be established for service charges (e.g., establishment, late payment, non-sufficient funds check, reconnection, re-establishment, etc.). Although the costs to provide customer services will vary by location, RUCO sees no significant impediment to establishing a standard methodology for establishing initial service charges in CC&N proceedings provided that RUCO is included in the process to establish the initial charges and any subsequent changes to those charges.

6) The Staff proposes the implementation of extensive rules pertaining to revenues and rates. The proposal is to establish standard, minimum monthly customer charges and commodity rates. The Commission Staff would recommend approval of the higher of the standard or company proposed rates. Under this proposal there would be no consideration as to whether rates were excessive. This plan justifies dismissing the possibility that rates may be excessive for three reasons. First, the probability of the company over-earning is small. Second, Staff would recommend an unspecified time-frame for the company to file a rate case. Third, there are no customers when the rates are established.

7) This proposal ignores the potential negative consequences of excessive initial rates. For example, customers may be driven away. Potential customers that would have preferred buying homes and beginning businesses in the service territory may select alternate locations. Taken to an extreme, a CC&N could be used to postpone growth in the service territory by charging excessive rates. A CC&N holder with the objective of limiting growth could prevent a developer from building in the service territory by

charging grossly excessive rates that no reasonable customer would pay. Also, the cost of service varies significantly by location. No single standard rates will prevent all new water companies from charging inadequate rates. New company's can benefit by the input from Commission Staff, RUCO, and other intervenors in setting rates. Prospective customers will also benefit from the input of multiple parties in developing a probable on-going level for rates in a new water system.

8) Establishing standard, minimum monthly customer charges and commodity rates does not ensure a proper balance of revenue from each. A company could choose the minimum monthly customer charges and select commodity rates far in excess of the minimum resulting in an unstable revenue base. Without an analysis of a company's projected underlying costs, the appropriate balance for a given company is unknown. Also, if a company were to choose an inappropriate balance for its initial rates, an unnecessarily large change in the rate structure may be warranted in a future rate case. Avoidance of large changes in rate structure is one of the fundamental goals of rate design. Thus, it is important that initial rates be set appropriately. In addition, the proposed minimum rates fail to address other issues including conservation objectives, the high cost of CAP water, and special customer demands, such as those of a prospective industrial user. The scrutiny provided by Staff, RUCO, developers, and hearing officers is valuable in forming appropriate initial rates and should not be discarded. Furthermore, providing water companies with full initial rate setting discretion is certain to be ill received by the public and public criticism would bring embarrassment to the Commission and RUCO even if real problems did not exist with is proposal.

RUCO, Staff & Industry proposal -

Encourage and create incentives for the consolidation for existing water companies

RUCO position on the concept -

RUCO believes consolidation of small water systems by larger well run companies would be in the public interest. RUCO is also aware that absent regulatory incentives, larger companies will not purchase smaller troubled water companies. It is important, however, that the incentives offered are appropriate, i.e. are not open to abuse, and are not offered in those situations were they are unnecessary to encourage the transaction. In other words, any incentive offered must be limited to transactions that would not occur except for the incentive. This effectively means incentives

should be limited too small (Class D & E) non-viable water companies.

PRO-

1) Encouraging the purchase of small non-viable water companies through regulatory incentives will provide the customers of those small systems with more reliable and better quality service. It will also ease the regulatory burden associated with numerous small systems.

2) If properly designed, incentives can remain in the control of the Commission while at the same time facilitating acquisitions and upgrading of small problem systems that would not otherwise occur, absent the incentive.

CON -

1) It is important that any incentive offered remains within the Commission's control. This objective would preclude the use of an acquisition premium (rate recovery of the purchase price in excess of book value) as a potential regulatory incentive. An acquisition adjustment would allow buyers and sellers of utility property to dictate the magnitude of the incentive through the buying and selling price. The higher the selling price, the greater the windfall profit to both buyer and seller, with captive ratepayers footing the bill.

2) Staff has developed a proposed set of criteria a utility would have to meet to qualify for an acquisition premium. While this criteria may ultimately be effective in preventing some of the dangers of allowing acquisition premiums, from a practical stand point would entail additional regulatory oversight, analysis, and create further demands on utilities as well as regulatory agencies. This is in conflict with the task force's stated goal of shorting and streamlining the regulatory process. This is an important point to keep in mind in examining any of the regulatory reforms proposed by the various parties to the task force. It is important that the vehicles and mechanisms we consider in our goal of regulatory reform don't further complicate and encumber an already burdensome process.

**ISSUE NO. 2 - STRENGTHEN THE FINANCIAL CAPABILITY OF THE
WATER INDUSTRY**

Industry and Staff Proposal -

Distribution infrastructure replacement cost recovery
mechanism

RUCO position on concept -

Such a mechanism, if properly designed, has the potential to promote the upgrading of deteriorating water systems, without harmful or biased rate impacts on customers.

PRO -

- 1) Would help facilitate the upgrading of aging water systems.
- 2) If designed after the Pennsylvania mechanism, would not allow utilities to recover investment prior to its used and usefulness.

CON-

- 1) Would allow the utility to circumvent regulatory lag that is unfavorable to the utility, but would not mitigate regulatory lag that is unfavorable to ratepayers. Potential matching/bias problem if not properly designed.
- 2) As proposed by Staff, this mechanism would pre-fund unidentified improvements, that were not known and measurable, nor used and useful, by creating a generic fund. This proposal is subject to too many unknowns and has a potential for numerous problems that are harmful to ratepayers. A mechanism as proposed by the industry that would mitigate the regulatory lag by recognizing certain plant improvements in rates, yet still require the improvements to be completed and in service prior to rate recognition would provide much more protection to ratepayers.

Industry proposal -

Expand utilization of pass through mechanism (Senate Bill 1252)

RUCO position on the concept -

Under the Industry proposal, utilities would be encouraged to avail themselves of the automatic pass-through provisions of Senate Bill 1252, by ensuring that the Commission only look at cost increases and not cost decreases. This is unacceptable and extremely biased against ratepayers.

PRO -

- 1) none

CON -

- 1) Will allow utilities to raise rates outside of a rate case for those costs that have increased yet would not recognize cost decreases. Highly biased against ratepayers.

Industry proposal -

Lower depreciation rates for small utilities and correct prior damage of too high depreciation rates

RUCO position concept -

RUCO agrees that depreciation rates that reflect the actual life of utility plant should be used instead of the generic 5% historically used by Staff for small utilities. We disagree however, that the rate bases of utilities that were subject to the 5% rate in the past should be retroactively restated to reflect actual lives.

PRO - 1) none

CON -

1) Under the Industry proposal, utilities that had already recovered their plant investment over 20 years through the 5% depreciation rate, would be allowed to reinstate a portion of the plant that had already been paid for by ratepayers and to collect it again from ratepayers. Regulation must provide for the opportunity to recover utility investment, but must not provide for double recoveries.

2) The Industry takes the position that if in any prior year a utility did not recover its depreciation expense (i.e. experienced an operating loss) then it should not be required to reflect the depreciation of its plant in its reserve account. This is contrary to ratemaking principles that allow an opportunity to earn a rate of return but not a guarantee. Further, there are a myriad of reasons why a utility experiences an operating loss. In order to implement a policy such as suggested by the Industry, ACC Staff would have to engage in post-mortem audits on utilities with operating losses to determine if retroactive recovery of expenses were appropriate. Such post-mortem rate reviews not only would further encumber the regulatory process, but also would result in a retroactive ratemaking system. Retroactive ratemaking is inconsistent with regulatory principles that offer an opportunity to earn a fair rate of return - not a guarantee.

Staff proposal -

Automatic rate changes

RUCO position on the concept -

RUCO believes automatic rate changes tied to the Consumer Price Index (CPI) is biased against ratepayers, and is not a concept that should be pursued.

PRO -

1) none

CON - 1) Staff's proposal to allow Class C, D & E utilities to carte blanche raise their rates based on a CPI inflation factor is highly biased against ratepayers and will result in annual rate increases without a finding of fair value. Staff's proposal would assume generic across-the-board expense increases, and would ignore the very real fact that costs also decrease. It would also allow utilities to raise rates without examining the mitigating offsets such as customer growth, consumption growth, and depreciation of the rate base.

Industry proposal -

Use of future or prospective test years

RUCO position on the concept -

RUCO strongly opposes the use of future (projected or prospective) test years. There are numerous problems with use of such test years. These include the setting of rates based on estimates that are not known and measurable, inclusion of plant in rates that is not used and useful, and violations of the matching concept when certain rate elements are projected or estimated and others are not. An historical test year inherently matches revenues, expenses, and investment, contains known and measurable data. The numerous problems and biases that result from the use of projected data far outweigh any potential benefit that could be derived from abandoning a historical test year.

PRO -

1) none

CON -

- 1) Projections and estimates forming the basis of permanent rates.
- 2) Mismatch of rate elements.
- 3) Inclusion of non-used and useful plant in rate base
- 4) Revenues, expenses, and investment are unauditable because these items are nothing more than estimates or projections.

Staff proposal -

Generic Hook-up fees

RUCO position on the concept -

RUCO agrees that working toward a recognized methodology for the use of hook-up fees is a desirable objective. Comments from

the water task force members on this issue were limited and more discussion on this topic is needed before proceeding with a recommendation to the Commission to initiate rule-making procedures.

PRO -

- 1) Free up time and resources currently expended on individual hook-up fee applications
- 2) Establish a consist rule or policy for all water utilities

CON -

- 1) Care must be used to ensure that the specific details of the generic hook-up fees do not create any undesirable or unanticipated impacts.

ISSUE NO. 3 - SIMPLIFYING, SHORTENING, AND REDUCING THE COST OF THE RATEMAKING PROCESS

Industry and Staff proposal -

Electronic filing of applications with ACC

RUCO position on the concept -

RUCO agrees with the concept of electronic filing

PRO -

- 1) Simplify and reduce the cost of rate filings

CON -

- 1) Feasibility dependant on ACC current technology and resources

Staff proposal -

Generic rate of return for all Arizona water companies

RUCO position on the concept -

The concept has merit and would simplify one aspect of a rate case
- rate of return

PRO -

- 1) Rate of return is typically a resource intensive portion of a rate case, and predetermining the rate would certainly simplify and shorten this portion of a rate case.

CON -

- 1) Rate of return for larger utilities is a highly material item. Further, rate of return, particularly cost of equity, is dependant on more than the current economic and financial environment. The individual characteristics of a utility effect rate of return (i.e. capital structure). For these reasons a "one-size-fits-all rate of return"

would most likely not be appropriate for larger utilities. RUCO believes generic rates of return should be used only for Class C or smaller utilities.

ISSUE # 4 - IMPROVE CUSTOMER EDUCATION

Industry and RUCO proposal -

ACC Web site, ACC water seminars across the state, continue publishing water news

RUCO position on the concept -

RUCO believes all of these proposals would be in the public interest

PRO -

1) Promote customer awareness, and deliver the information necessary for resolving problems.

CON -

1) The ACC, as a state agency with a finite appropriation, may not have resources available for these items. May require additional appropriation.

Industry proposal -

Utility newsletters, utility "Customer Service Reference Guide"

RUCO position on the concept -

RUCO supports the Industry's proposal to participate in the customer education process.

PRO -

1) Create customer awareness, and promote good relations with community in which the utility operates.

CON -

1) Is subject to the availability of spare utility resources, which for small utilities in particular may not be possible.

Industry and Staff proposal -

RUCO publication that explains the basics of ratemaking and informs customers of their various options in participating in the ratemaking process.

RUCO position concept -

Such a publication would be in the public interest

PRO -

- 1) Promote ratepayer awareness
- 2) Free up time currently expended in individually responding to customer inquiries regarding the ratemaking process and customer rights.

CON -

- 1) RUCO's current appropriation does not contain funding for such a project. Additional appropriation would be necessary.

Staff proposal -

Company specific Main Extension Agreements (MXA)

RUCO position on the concept -

RUCO believes the proposal to set up MXAs in the form of a tariff for each water company has merit.

PRO -

- 1) Will eliminate the redundancy of approval of each individual agreement a utility enters into with developers and customers.

CON -

- 1) As with other regulatory reform proposals, care will need to be taken to ensure that the final rule on MXA's will not create any new regulatory problems or have any unanticipated adverse impacts on customers.

ISSUE # 5 - INCREASE INTERAGENCY COORDINATION

Industry and Staff position -

Neither Staff nor the Industry took a position on this issue in their original comments. Consequently RUCO has no reply.

OTHER ISSUES

The Staff in its filed comments has set forth some issues, which were not identified by the task force as goals for regulatory reform. Nevertheless our response is discussed below:

Staff proposal -

Generic rate design

RUCO position concept -

In RUCO's opinion, the water task force has failed to identify any suggestions pertaining to rate design that are worthy of additional rule-making consideration. Comments regarding rate design made by members of the task force to this point fail to capture the essence, purpose, importance, and complexity of rate design; are unsound and supportable; and generate a plethora of inequities, new problems, and unanswered questions.

PRO -

none

CON -

1) There is no credible study that demonstrates that inverted tier rate designs inherently promote conservation. For regulated utilities, where there is a target revenue requirement, the notion that an inverted tier rate structure automatically encourages a reduction in consumption is contrary to economic theory. There is no study that supports the underlying assumption that the elasticity of water is greater for large users than smaller users. Even if the consumption characteristics of some water company could be shown to be consistent with the assumption that elasticity is directly proportional to usage, it is not a universal truth that should be applied to all water systems.

2) The widely recognized primary purpose of rate design is to align rates with the cost of service. Even where conservation is a major consideration, the relationship between price and cost of service generally remains the primary purpose of rates. Education and water audits are generally recognized as significant factors of conservation programs. There is no basis for using rate design as the primary conservation mechanism.

3) The recommendation to use revenue from the "highest tier" to provide more than the approved rate of return is wrought with problems and ambiguities. How is "over-earning" defined? Who would assess the amount of the over-earnings? How would the over-earnings be treated, e.g., as a contribution? How would the over-earning be treated for tax treatment? Does this over-earnings essentially guarantee the authorized rate of return? If so, should the reduced risk be reflected as by a lower rate of return? Would failure to over-earn be given special treatment? Is the cost and effort for Staff, RUCO, and utilities to have audits conducted of the highest tier revenues justified by any benefits gained from this methodology? Is the suggestion to require utilities to file rate cases at least once every five years really necessary?

4) Rate design is one of the most important aspects of setting rates for public service corporations. A customer whose rates are excessive due to improper rate design is no less harmed than when a utility is allowed an excessive rate of return. The only rate design proposal presented by members of the task force would, apparently, allow both of these transgressions. This would be incompetent and derelict, and it is simply unacceptable. Ratepayers deserve properly designed rates. Due to the complex nature of rate design and the many varying circumstances of water system - it is unlikely that any scripted methodology for designing rates would be appropriate.

WATER SUPPLY SUBCOMMITTEE

The Water Supply Subcommittee was charged with discussing issues of long-term water supply for water utilities under the jurisdiction of the Arizona Corporation Commission ("Commission"). The Subcommittee quickly narrowed the issue to the potential recovery of Central Arizona Project ("CAP") costs by water utilities.

ISSUE:

Under what circumstances should CAP expenses be recovered by water utilities?

Staff proposal:

CAP costs should be recovered on an interim basis once a company has a plan approved by the Commission to use CAP water within five years of the approval of the plan.

Arizona Department of Water Resources:

DWR takes Staff's suggestion noted above and suggests that capital charges for the entire allocation should be recoverable immediately if the provider develops a plan that demonstrates certain criteria.

RUCO Proposal:

As RUCO adheres to the used and useful ratemaking principle, each utility must be using CAP water before such costs may be recovered. "Using" CAP water is not limited to the water flowing through the utilities' pipes, but by the use of groundwater replenishment, water exchange agreements, etc. RUCO's position in the recent Paradise Valley Water Company ("Paradise Valley") rate case (Decision No. 61831) recommended approval of Paradise Valley's use of a water exchange agreement with Salt River Project.

RUCO also recently filed testimony in the application of Citizens Utilities' Sun City Water Company and the Sun City West Utilities Company for approval of a CAP

utilization plan and for an accounting order on deferred charges and the annual ongoing costs of CAP water. RUCO recommends approval of the companies' interim plan to deliver its entire CAP allocation to the Maricopa Water District groundwater saving project ("MWD"). For every acre foot of groundwater not pumped by the farmers in the MWD, Sun City and Sun City West will be able to draw water from wells to meet existing demand in their respective service territories. RUCO also recommends the recovery of the deferred CAP charges and the annual ongoing costs of the CAP water.

Other water companies should look to such utilities to determine whether a similar mechanism may be appropriate in order to "use" their CAP allocations. Until a water company has a CAP water usage plan implemented with CAP water "used", the costs of CAP water should be borne by the utility and not by ratepayers.

PRO:

Ideally, water utilities should already have been planning how to use their CAP allocations. Such plans should facilitate the use of CAP water so that ratepayers see a concrete benefit and the groundwater policies of Arizona are furthered. Perhaps utilities that have not begun planning how to use their CAP allocations will begin to do so.

CON:

The CAP water is not benefiting ratepayers when the CAP water is not being used, whether by actual use by the utility, by a water exchange agreement or by groundwater replenishment. Utilities should have been planning how to use their CAP allocations as a part of their business plans. A utility should not recover costs based on an idea about how to potentially use their CAP allocation in the future. As many intervening events may occur before a utility actually begins to "use" its allocation, it is too speculative and hypothetical to burden ratepayers with a CAP charge when they will not receive benefits for a number of years, if ever. There are a few recent examples where water utilities have implemented the "use" of their CAP allocations through exchanges and ground water saving projects. Other water utilities should look to those companies to determine what the best options are to "use" their CAP allocations.

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK

Chairman

JIM IRVIN

Commissioner

WILLIAM A. MUNDELL

Commissioner

Arizona Corporation Commission

DOCKETED

NOV 03 2000

DOCKETED BY

RT

IN THE MATTER OF THE ARIZONA
CORPORATION COMMISSION'S OWN
MOTION TO ESTABLISH THE COMMISSION
WATER TASK FORCE

DOCKET NO. W-00000C-98-0153

DECISION NO. 62993ORDER

Open Meeting
October 24 and 25, 2000
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

1. On April 24, 1998, in Decision No. 60829, the Arizona Corporation Commission (Commission) established the Commission Water Task Force (Task Force). The Task Force consists of representatives of regulatory agencies, the water providers, and water consumers. On September 22, 1998, the Task Force held its first meeting. The Task Force meetings were all noticed Open Meetings.

2. On October 28, 1999, the Task Force completed its Report for the Commission (Report). The Report contains recommendations to the Commission on several issues facing Arizona's water industry. On many issues, the Task Force achieved consensus. On other issues, the Report contains different recommendations from the various Task Force members.

3. On January 5, 2000, the Task Force Report was docketed and distributed to every Arizona water company regulated by the Commission. A deadline of March 15, 2000, was set for comments on the Report to be filed. Only two water companies and the Central Arizona Project (CAP) submitted comments. Arizona Water Company generally supports the Staff's proposals, but does express some reservations. Lakewood Water Company, a small water company in Amado, indicates that it is currently struggling with the financial requirements to fund necessary capital improvements. The capital costs to make improvements would double the rates for the company's customers, many of whom are low-income. The company expresses interest in the possibility of

Decision No. 62993

1 consolidation with other water utilities. The CAP generally supports Staff's proposals, but it dr
2 express some reservations.

3 4. The Task Force was divided into three subcommittees: the Regulatory Reform
4 Subcommittee, the Conservation Subcommittee, and the Water Supply Subcommittee. The Regulatory
5 Reform Subcommittee achieved consensus on five goals:

- 6 • Reduce the number of small, non-viable water systems through new rules and procedures.
- 7 • Strengthen the financial capacity of the water utility industry.
- 8 • Provide greater emphasis on simplifying, shortening, and reducing the cost of the
- 9 ratemaking process.
- 10 • Improve consumer education.
- 11 • Increase interagency coordination.
- 12
- 13

14 5. The Conservation Subcommittee focused on developing policies the Commission coul
15 use to encourage water conservation. The Water Supply Subcommittee focused on issues relevant to
16 renewable and surface water supply, such as the Central Arizona Project.

17 **Regulatory Reform Subcommittee**

18 6. On Pages 3 through 25 of the Report, the Regulatory Reform Subcommittee's
19 recommendations and discussions are summarized.

20 7. On Pages 4 through 7 of the Report, Staff's proposal on placing more stringent
21 requirements on approval of CC&Ns for new water companies is discussed.

22 8. Commission Staff recommended the following Commission policy changes concerning
23 the establishment of new water companies:

- 24 a. The application for a new CC&N must show that an existing water company cannot
25 or will not serve the area being applied for. This showing must be made by submitting
26 service rejection letters from all the "A" size water companies in the state (there are 3)
27 and at least five of the "B" size companies (there are 20). The five B size companies
28 contacted should include the B size companies that are geographically closest to th
applicant. The application must also be accompanied by service rejection letters

1 from all the existing water companies within five miles of the area being requested. In
2 addition, the rejection letters must be accompanied by the corresponding request for
3 service that was made to each of the existing water companies by the applicant.

- 4 b. The rates should be set such that the company should at least break even no later than
5 its third year of operation. The calculations would be based on the company's
6 reasonable estimates of customer growth. The company should also be required to
7 come in for a rate case three years after serving its first permanent customer.
- 8 c. Because Staff believes that it is not in the public interest, no new CC&N would be
9 issued to any company that was affiliated with any other company or person that was
10 not in total or substantial compliance with Commission and ADEQ requirements. This
11 restriction should apply to CC&N extensions and transfers as well.
- 12 d. Staff recommends establishing a set of standard service charges for new CC&Ns.
- 13 e. Staff will work with the ADWR to establish tiered rate structures for new CC&Ns.

14 9. Staff recommends that the Commission endorse Staff's recommendations. Further,
15 Staff requests that the Commission order Staff to develop (through meetings with members of the
16 industry, RUCO, and other interested parties) a detailed statement of policy on water CC&Ns by
17 June 30, 2001. The detailed statement of policy should conform to the general principals of Staff's
18 recommendation contained in the Report and the above discussion. Staff members who are
19 responsible for processing new water CC&N requests should be responsible for conducting these;
20 meetings and developing the detailed statement of policy.

21 10. On Pages 8 through 11 of the Report, several proposals for providing incentives for
22 consolidation in the water industry are discussed. Staff recommends that an acquisition adjustment
23 or a rate of return premium (but not both) be allowed under certain conditions. These conditions are:

- 24 • The acquisition is in the public interest;
- 25 • The acquisition will not negatively affect the viability of the acquirer;
- 26 • The acquired system's customers will receive improved service in a reasonable timeframe;
- 27 • The purchase price is fair and reasonable (even though that price may be more than the
28 original cost less depreciation book value) and conducted through an arms' length
negotiation;

- The recovery period for the acquisition adjustment should be for a specific minimum time (e.g., twenty years); and
- The acquired company is a class D or E.

11. Staff does not recommend allowing for acquisition adjustments unless all of the above conditions are met. Staff believes that the burden should be on the company to prove that an acquisition adjustment or a rate of return premium is in the public interest. The public interest determination should account for the capital investments needed for the customers to receive improved service and the costs savings the company is likely to realize through economies of scale. Other methods of encouraging consolidation include allowing for rate of return premiums and deferral accounting orders. Staff recommends that the Commission endorse Staff's recommendation. Further, Staff requests that the Commission order Staff to develop, through meetings with members of the industry, RUCO, and other interested parties, a detailed statement of policy on acquisition adjustments and rate of return premiums by June 30, 2001. The detailed statement of policy should conform to the general principals of Staff's recommendation contained above and in the Report. Staff members who are responsible for recommending approval or denial of acquisition adjustment requests should be responsible for conducting these meetings and developing the detailed statement of policy.

12. Other incentives for consolidation could be provided by the State Legislature. Tax breaks or credits could be provided to companies that choose to acquire small and/or financially non-viable water companies. The Staff requests the Commission adopt recommendations to the Legislature regarding incentives for consolidation and direct the Commission's Legislative Liaison to initiate efforts to encourage the Legislature to adopt these incentives.

13. The establishment of a fund similar to the Universal Service Fund used for telecommunications firms, is another option for improving the financial capacity of small water companies. A fund that all water companies pay into and that financially strapped companies could draw out of for infrastructure investments could be established. For fairness purposes municipal water

...

...

1 companies would need to be included as contributors/beneficiaries of the fund. This would require
2 legislation as well as changes to the Commission rules. Staff proposes this fund as an approach the
3 Commission may want to consider in the future.

4 14. Issues involving property taxes are discussed on Pages 12 and 13 of the Report. The
5 Staff requests the Commission adopt recommendations to the Legislature regarding alternative taxation
6 mechanisms for private water companies and direct the Commission's Legislative Liaison to initiate
7 efforts to encourage the Legislature to adopt these tax alternatives. Staff also recommends that the
8 Accounting and Rates (A&R) section of the Utilities Division sponsor, for any interested party, a
9 seminar on the ratemaking implications of property taxes, focusing on the problems the industry
10 outlines in the Report.

11 15. On Pages 14 and 15 of the Report, the Future Test Year issue is discussed. Staff
12 believes that there is no need to change the present method used by the Commission. At present, the
13 Commission employs an historical test year but does allow for pro forma additions for known and
14 measurable costs. It is Staff's opinion that this is a very good combination of both historical and future
15 test years. Presently, this is done on a case-by-case basis. Staff believes that this method could be
16 improved, therefore, Staff recommends that the Commission order Staff to develop a policy with
17 specific requirements for expense changes, revenue changes, and plant additions that occur after the
18 test year. Such items would include, but are not limited to:

- 19
- 20 a. Method of matching new expenses with new revenues.
 - 21 b. Revenue neutral plant, i.e., plant to serve existing, not future, customers.
 - 22 c. Revenue neutral plant will be installed within a specific timeframe, preferably one year.
 - 23 d. Revenue neutral plant is necessary to provide proper and adequate service to existing
 - 24 customers.

25 16. On Pages 15 and 16 of the Report, Staff's recommended Generic Hook-up Fee policy
26 is outlined. Both the industry and RUCO support Staff's recommendation in principal. Staff believes
27 that implementing this recommendation will require a rulemaking proceeding. Staff requests that the

28 ...

1 Commission order a rule making proceeding be opened to implement a Generic Hook-up Fee polir
2 along the lines of Staff's proposal.

3 17. On Pages 16 through 19 of the Report, proposals for plant replacement fund
4 mechanisms are discussed. Staff recommends that the Commission adopt a policy similar to the
5 Pennsylvania Public Utilities Commission's Distribution Service Investment Charge (DSIC). Staff
6 requests that the Commission order a rule making proceeding be opened to implement rules for a DSIC
7 or similar program in Arizona.

8 18. On Pages 19 and 20 of the Report, problems associated with past high depreciation
9 rates are discussed. The industry offered proposals on how to rectify these problems; however, Staff
10 and RUCO found those approaches to be inappropriate. Staff believes that its proposed Rate of Return
11 policy (discussed below) will solve the problems associated with past excessive depreciation rates. All
12 parties agreed that the Commission should no longer approve excessive depreciation rates for small
13 water companies.

14 19. On Pages 20 and 21 of the Report the pass-through mechanism approved by the
15 legislature in SB 1252 (now A.R.S. § 40-370) is discussed. The industry representatives on the Task
16 Force felt that the Commission's policy on A.R.S. § 40-370 needed to be clarified because, at the time
17 the Report was written, only one company had applied for authority to adjust rates under the provisions
18 of this mechanism. Since then the Commission has approved two such applications (they both have
19 been appealed). The two approved applications were for Arizona Water Company's Monitoring
20 Assistance Program (Decision No. 62141) and Rio Verde Utilities, Inc.'s CAP cost increase (Decision
21 No. 62037). Those two decisions indicate that the Commission's policy on A.R.S. § 40-370
22 applications is to support appropriate pass-throughs, which should mitigate the industries concerns.

23 20. On Pages 21 and 22 of the Report, Staff's proposed Rate of Return policy is outlined.
24 Staff believes that implementing this policy will solve the problems associated with high depreciation
25 rates and lead to other improvements. This policy would make filing rate cases much less burdensome
26 for small water companies. Staff's proposed policy allows companies that are filing rate applications
27 to choose between 1) a generic rate of return (for C, D, and E companies only); 2) setting rates based
28 on an operating margin basis (i.e., no rate of return consideration); or 3) an individual rate of return

1 (i.e., traditional rate making). In addition to the recommendations in the Report, Staff is
2 recommending that the choice of the generic rate of return be limited to C, D, and E companies. Also,
3 Staff recommends that the generic rate of return should be a minimum rate of return; thus, points can
4 be added to it to account for special expenses such as WIFA loan payments. Staff requests that the
5 Commission order a rule making proceeding be opened to implement Staff's proposed Rate of Return
6 policy. Staff is aware that the recent Court of Appeals Opinion may impact the Commission's ability
7 to implement Staff's proposed rate of return policy. Staff believes that the issues raised by the Court
8 of Appeals Opinion are best dealt with during the rulemaking proceedings.

9 21. On Pages 22 and 23 of the Report, the electronic filing of annual Reports, rate cases,
10 and other filings with the Commission is discussed. Staff, the industry, and RUCO all agreed that
11 allowing for electronic filing would be beneficial. Staff has already initiated the first steps of this
12 process by making the Short Rate Case Form available on the Commission's web site. Staff is
13 committed to making all of its forms available electronically. In order to institute full electronic filing,
14 the Hearing Division will need to be involved. Staff is committed to working with the Hearing
15 Division to develop a process that will allow for full electronic filing.

16 22. During the Task Force's discussions of electronic filing, the industry also expressed
17 concern about the volume and extent of the Commission's filing requirements. Staff acknowledges
18 that certain filing requirements may be out-dated. Staff is currently reviewing all forms and filing
19 requirements. However, such a review is a major undertaking and may take some time to complete.

20 23. On Page 23 of the Report, Staff's Main Extension Agreement (MXA) proposal is
21 outlined. Staff's proposal is to have standard MXA provisions included in each water companies
22 tariffs, instead of the current process of approving MXAs on an individual case basis. Both the
23 industry and RUCO supported Staff on this issue. Staff requests that the Commission order a rule
24 making proceeding be opened to implement Staff's proposed MXA policy.

25 24. On Pages 23 and 24 of the Report, several suggestions concerning consumer education
26 are discussed. Staff is currently working on educational programs for all industries the Commission
27 regulates. Implementing any educational program may require additional funds from the Legislature.
28 Staff is also evaluating the expansion of its well-regarded Small Water Assistance Team (SWAT)

1 program (which deals with educating water company owners/operators) to include education for water
2 consumers.

3 25. On Pages 24 and 25 of the Report, Staff's Phased Rate Increase policy is discussed.
4 Staff believes that in certain limited circumstances it is appropriate to phase rate increases in over
5 time. Staff will develop well-defined guidelines for when and how phased rate increases are
6 appropriate.

7 26. On Page 25 of the Report, Staff's recommendation on rates tied to conditions is
8 discussed. Staff recommends that all rate increases be conditioned on the company providing
9 acceptable quality service, water quality, and other relevant conditions. Staff has already implemented
10 this policy informally by including specific conditions in recent Recommended Orders. Staff will
11 develop a standard set of conditions that could apply to all water companies. One impediment to this
12 policy being successful is the Commission's lack of enforcement resources. Currently, the Utilities
13 division has one compliance officer to handle *all of the utilities* the Commission regulates.

14 **Conservation Subcommittee**

15 27. On Pages 26 through 29 of the Report, the Conservation Subcommittee's
16 recommendations and discussions are described. On Pages 26 through 28, a perceived problem with
17 the Commission's conservation policy is discussed. The industry and consumer members of the Task
18 Force as well as the ADWR representatives believed that the Commission would not allow companies
19 to include the costs of conservation programs in rates unless the conservation program was mandated
20 by the ADWR. If this were true, it would discourage companies from engaging in conservation
21 programs. However, Staff does not believe that this is true. No member of the Task Force could site
22 any examples of instances where Staff has recommended denial of conservation program costs or
23 where the Commission approved an order that included the denial of conservation programs and their
24 reasonable costs. Staff supports and encourages conservation. Staff believes that recovery of any
25 reasonable costs for conservation programs should be allowed.

26 28. On Pages 28 and 29, Staff's proposal to institute three tiered rates is discussed. Tiered
27 rates are the Commission's only direct means of encouraging conservation. Both the industry and
28 RUCO opposed Staff's proposal. The industry claimed that it is sure to result in companies

1 underearning, while RUCO claimed the policy is sure to result in companies overearning. Staff
2 believes that as with any rate design there is a possibility of either over or underearning. However,
3 with rates designed as proposed by Staff in the Task Force's Report there is almost no chance of
4 underearning while there is a good possibility of overearning. If properly designed though, the tiered
5 rates would result in the non-conserving customers paying extra for large uses of water and reward
6 those customers that used very little water. If customers conserved such that all were falling within
7 the middle tier, the company should earn its allowed rate of return. If the customers continued to use
8 water in the third tier, the water company would probably overearn. The use of the overearnings could
9 be restricted by the Commission in such a manner as to benefit the customers. Staff realizes that this
10 is a new and different way of looking at rate design combined with conservation, but Staff also realizes
11 that new ways have to be considered to save what many consider to be this State's most precious
12 resource. Staff recommends that the Commission order Staff to consider tiered rate designs for all
13 water company rate cases and that the tiers be designed to encourage conservation. Staff recognizes
14 that tiered rates may not be appropriate in all cases and that the decision to use or not use tiered rates
15 must be made on a case-by-case basis. However, the appropriateness of tiered rates should be
16 considered in every case. Further, Staff requests that the Commission order Staff to develop a detailed
17 statement of policy on tiered rates by June 30, 2001.

18 Water Supply

19 29. On Pages 30 through 33 of the Report, the Water Supply Subcommittee's
20 recommendations and discussions are summarized. The main focus of this subcommittee was the
21 recovery of Central Arizona Project (CAP) water allocation costs (CAP costs). All members of the
22 Subcommittee agreed that the Commission could somehow approve the recovery of CAP costs in a
23 proceeding outside of a rate case. However, the Commission's Legal division has concluded that
24 considering CAP costs outside of a rate case would run counter to the recent Court of Appeals opinion
25 on fair value. There was disagreement among the Subcommittee members about what the
26 Commission should require before it allows for CAP cost recovery. In the Report, Staff recommended
27 that the Commission allow for CAP cost recovery once the company has submitted a plan that
28 indicates how they will begin to actually use their CAP allocations within five years. Staff chose a

1 five-year time horizon because Staff wished to limit the extent to which current customers are charged
2 for CAP allocations which will only be used to serve future customers.

3 30. Since the Report was written, Staff has modified its position. Staff believes that the
4 Commission should be more flexible with the time horizon it allows for CAP water to go unused while
5 allowing cost recovery. Staff believes that the time requirement placed on companies applying for
6 CAP cost recovery should be decided on a case by case basis. Also, to ensure that current customers
7 do not pay an unfair amount relative to future customers, a portion of the CAP cost should be
8 recovered through some type of hook-up fee. The amount of the recovery that is recovered through
9 a hook-up fee should be determined by the company's total demand for water relative to its CAP
10 allocation. For example, if a company's total demand is 200,000 gallons per year and its CAP
11 allocation is 1,000,000 gallons per year, then the company should recovery 20 percent of its CAP cost
12 from current customers and the remaining 80 percent from hook-up fees. The methodology used for
13 CAP cost recovery in the Vail Water Company Rate Case (Decision No. 62450) is an example of the
14 general policy that Staff advocates.

15 31. Staff requests that the Commission order Staff to develop, through meetings with
16 members of the industry, RUCO, and other interested parties, a detailed statement of policy on CAP
17 cost recovery by June 30, 2001. The detailed statement of policy should conform to the recovery
18 methodologies used in the Vail Rate Case, Decision No. 62450.

19 Conclusions

20 32. In conclusion, Staff recommends several changes in and clarifications of Commission
21 policy, several changes to the Commission's rules, and that the Commission pursue several Legislative
22 changes. These recommendations are summarized as follows:

23 Policy Changes

- 24 • CC&Ns (new, transfers, and extensions)
- 25 • Acquisition Adjustments and Rate of Return Premiums
- 26 • Seminar on ratemaking implications of property taxes
- 27 • Electronic Filing and review of filing requirements
- 28 • Phased Rate Increase
- Rates tied to Conditions
- Tiered Rate Structure

- CAP cost recovery
- Pro forma adjustments

Rulemaking

- Generic Hook Up Fee
- Rate of Return
- Main Extension Agreements
- Plant Replacement Fund

Legislative Changes

- Incentives for consolidation, e.g. tax breaks
- Replace property taxes with a percentage of revenue tax

33. Staff recommends that the Commission endorse the above policy and Legislative changes. Also, Staff recommends that the Commission open a rulemaking proceeding in order to implement the above changes to the Commission rules.

CONCLUSIONS OF LAW

1. The Commission as the regulatory body with the longest history and the primary responsibility over private water companies should take the lead in seeking a coordinated solution to the problems of small water companies.

2. The Commission arranged for the formation of the Task Force for meetings between representatives of regulatory agencies, the water providers, and water consumers in order to address these issues.

3. The Task Force has issued a report that summarizes the views of its members.

ORDER

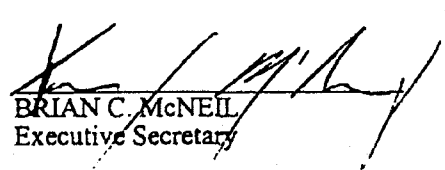
THEREFORE, IT IS ORDERED that the Commission approve Staff's recommendations in the above Findings of Fact.

IT IS FURTHER ORDERED that this decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION


CHAIRMAN
COMMISSIONER
COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this 3rd day of November 2000.


BRIAN C. McNEIL
Executive Secretary

DISSENT: _____

DRS:MJR:lh

Decision No. 62993

COMMISSION APPROVED RETURNS ON EQUITY (ROE) FOR OTHER ARIZONA UTILITIES (2004-2010)

	BOCKET NO.	COMPANY	DECISION N.N.O.	DATE	UTILITY ROE	RUCO ROE	STAFF ROE	APPROVED ROE	APPROVED WACC	ACTUAL DEBT	ACTUAL EQUITY	HYPOTHECAL DEBT	HYPOTHECAL EQUITY
1	09-0291	Concavo Utilities	71956	11/1/2010	10.00%	n/a	10.50%	10.50%	7.25%	0.00%	36.70%	n/a	n/a
2	09-0077	Global Water-Palo Verde	71878	9/15/2010	10.00%	9.00%	10.00%	10.00%	7.80%	0.00%	100.00%	45.30%	54.70%
3	09-0077	Global Water-Santa Cruz	71878	9/15/2010	10.00%	9.00%	10.00%	10.00%	7.95%	0.00%	100.00%	43.90%	56.10%
4	09-0077	Global Water-Greater Phoenix	71878	9/15/2010	10.00%	9.00%	10.00%	10.00%	7.68%	0.00%	100.00%	45.10%	54.90%
5	09-0077	Global Water-Valencia Town	71878	9/15/2010	10.00%	9.00%	10.00%	10.00%	8.08%	0.00%	100.00%	45.10%	54.90%
6	09-0077	Global Water-Willow Valley	71878	9/15/2010	10.00%	9.00%	10.00%	10.00%	7.60%	0.00%	100.00%	45.10%	54.90%
7	08-0609	Black Mountain Sewer Corporation	71865	9/1/2010	12.40%	8.25%	10.20%	10.20%	9.41%	0.00%	100.00%	20.00%	80.00%
8	09-0103	Litchfield Park Service Company	72026	12/10/2010	12.00%	9.00%	9.20%	9.20%	7.72%	0.00%	100.00%	20.00%	80.00%
9	08-0440	Arizona Water Company	71845	8/25/2010	11.20%	8.33%	10.00%	10.00%	7.87%	0.00%	100.00%	20.00%	80.00%
10	08-0440	Arizona Water Company	72047	1/6/2011	11.20%	8.33%	10.00%	10.00%	7.87%	0.00%	100.00%	20.00%	80.00%
11	08-0571	UNIS Gas, Inc.	71633	4/1/2010	11.00%	8.61%	10.00%	10.00%	8.00%	0.00%	100.00%	20.00%	80.00%
12	08-0406	Surfside Water Co.	71445	12/31/2009	10.00%	n/a	10.00%	10.00%	10.00%	0.00%	100.00%	20.00%	80.00%
13	08-0406	Arizona-American Water	71445	12/31/2009	11.75%	8.88%	10.00%	10.00%	7.33%	0.00%	100.00%	20.00%	80.00%
14	07-0451	Chandler City Water Co.	71308	10/21/2009	11.50%	8.83%	10.10%	10.10%	7.52%	0.00%	100.00%	20.00%	80.00%
15	06-0015	Gold Canyon Sewer Company	70624	11/19/2008	10.50%	8.05%	9.20%	9.20%	8.54%	0.00%	100.00%	20.00%	80.00%
16	06-0403	Arizona-American Anthem Water District	70372	6/13/2008	11.75%	10.01%	10.30%	10.30%	8.70%	0.00%	100.00%	20.00%	80.00%
17	06-0403	Arizona-American Anthem/Aqua Fria Wastewater District	70372	6/13/2008	11.75%	10.01%	10.30%	10.30%	8.80%	0.00%	100.00%	20.00%	80.00%
18	06-0403	Arizona-American Anthem/Aqua Fria Wastewater District	70209	7/29/2008	11.75%	10.03%	10.60%	10.60%	7.50%	0.00%	100.00%	20.00%	80.00%
19	06-0491	Arizona-American Sun City West Wastewater District	70209	7/29/2008	11.75%	10.03%	10.60%	10.60%	7.50%	0.00%	100.00%	20.00%	80.00%
20	06-0463	UNIS Gas, Inc.	70011	11/27/2007	11.00%	9.44%	10.00%	10.00%	8.10%	0.00%	100.00%	20.00%	80.00%
21	07-0209	Arizona-American Sun City Water District	70351	5/16/2007	11.50%	9.89%	10.80%	10.80%	7.60%	0.00%	100.00%	20.00%	80.00%
22	06-0014	Arizona-American Mohave Water District	69440	5/1/2007	11.50%	9.10%	10.70%	10.70%	7.71%	0.00%	100.00%	20.00%	80.00%
23	06-0014	Arizona-American Mohave Wastewater District	69440	5/1/2007	11.50%	9.10%	10.70%	10.70%	7.71%	0.00%	100.00%	20.00%	80.00%
24	05-0801	Far West Water and Sewer Company	69335	2/29/2007	10.50%	9.04%	9.30%	9.30%	7.80%	0.00%	100.00%	20.00%	80.00%
25	07-0402	Tucson Electric Power Company	70628	12/1/2008	10.75%	9.44%	10.25%	10.25%	8.03%	0.00%	100.00%	20.00%	80.00%
26	05-0405	Arizona-American Paradise Valley Water District	68858	7/28/2006	12.00%	10.00%	10.40%	10.40%	7.24%	0.00%	100.00%	20.00%	80.00%
27	04-0616	Arizona Water Company Western Group	68102	11/14/2005	11.25%	9.44%	9.10%	9.10%	8.50%	0.00%	100.00%	20.00%	80.00%
28	03-0434	Chaparral City Water Co.	68176	9/30/2005	11.00%	9.45%	9.30%	9.30%	7.60%	0.00%	100.00%	20.00%	80.00%
29	02-0908	Rio Rico Utilities, Inc.	67279	10/5/2004	10.00%	8.83%	8.60%	8.60%	8.70%	0.00%	100.00%	20.00%	80.00%
30	02-0908	Arizona-American Sun City Water	67093	6/30/2004	11.60%	9.61%	9.00%	9.00%	6.50%	0.00%	100.00%	20.00%	80.00%
31	02-0908	Arizona-American Sun City Wastewater	67093	6/30/2004	11.60%	9.61%	9.00%	9.00%	6.50%	0.00%	100.00%	20.00%	80.00%
32	02-0908	Arizona-American Sun City West Water	67093	6/30/2004	11.60%	9.61%	9.00%	9.00%	6.50%	0.00%	100.00%	20.00%	80.00%
33	02-0908	Arizona-American Mohave Water	67093	6/30/2004	11.60%	9.61%	9.00%	9.00%	6.50%	0.00%	100.00%	20.00%	80.00%
34	02-0908	Arizona-American Anthem Water	67093	6/30/2004	11.60%	9.61%	9.00%	9.00%	6.50%	0.00%	100.00%	20.00%	80.00%
35	02-0908	Arizona-American Anthem/Aqua Fria Wastewater	67093	6/30/2004	11.60%	9.61%	9.00%	9.00%	6.50%	0.00%	100.00%	20.00%	80.00%
36	02-0908	Arizona-American Anthem/Aqua Fria Wastewater	67093	6/30/2004	11.60%	9.61%	9.00%	9.00%	6.50%	0.00%	100.00%	20.00%	80.00%
37	02-0908	Arizona-American Tuba City	67093	6/30/2004	11.60%	9.61%	9.00%	9.00%	6.50%	0.00%	100.00%	20.00%	80.00%
38	02-0619	Arizona Water Company Eastern Group	66849	3/19/2004	12.40%	9.18%	9.00%	9.00%	8.70%	0.00%	100.00%	20.00%	80.00%
39	AVERAGE OF ARIZONA 2004-2006 DECISIONS				11.46%	9.52%	9.88%	9.88%	8.41%				
40	MEDIAN OF ARIZONA 2004-2006 DECISIONS				11.58%	9.80%	9.80%	9.80%	10.61%				
41	AVERAGE OF ARIZONA 2007 DECISIONS				11.30%	9.40%	10.63%	10.63%					
42	MEDIAN OF ARIZONA 2007 DECISIONS				11.30%	9.40%	10.63%	10.63%					
43	AVERAGE OF ARIZONA 2008 DECISIONS				11.30%	9.40%	10.63%	10.63%					
44	MEDIAN OF ARIZONA 2008 DECISIONS				11.30%	9.40%	10.63%	10.63%					
45	AVERAGE OF ARIZONA 2009 DECISIONS				11.30%	9.40%	10.63%	10.63%					
46	MEDIAN OF ARIZONA 2009 DECISIONS				11.30%	9.40%	10.63%	10.63%					
47	AVERAGE OF ARIZONA 2010 DECISIONS				11.30%	9.40%	10.63%	10.63%					
48	MEDIAN OF ARIZONA 2010 DECISIONS				11.30%	9.40%	10.63%	10.63%					
49	AVERAGE OF ARIZONA 2011 DECISIONS				11.30%	9.40%	10.63%	10.63%					
50	MEDIAN OF ARIZONA 2011 DECISIONS				11.30%	9.40%	10.63%	10.63%					

Return On Equity

REGULATORS TRUST, BUT VERIFY

Some recent utility rate proceedings cast doubt on new ROE models and “risk adders.”



BY PHILLIP S. CROSS

The results of *Public Utilities Fortnightly's* annual survey of rates of return on equity (ROE) authorized for major electric and natural-gas utilities broadly show a continuing decline in the level of debate over issues specific to restructuring of the electric market. The survey also reveals a subtle shift back to investor requirements and overall business risks faced by regulated energy companies.

For example, in a gas rate case decided in Nevada, regulators rejected an ROE “risk adder” proposed by a natural-gas local distribution company and reminded the utility that hard evidence such as credit ratings and regulatory rulings are what makes the difference in a rate-case setting.

The Illinois Commerce Commission reviewed the underpinnings of the traditional ROE process when it rejected a proposal by a party to a major electric rate case to switch to a completely new approach, purportedly based on direct evidence from the investment-banking community. As it turned out, the so-called “investment-bank analysis” produced an ROE estimate much lower than any produced by the standard financial models normally relied upon in rate cases. The commission concluded it had no way to know what assumptions investment bankers use when putting a value on utility stocks, or whether such an estimate might satisfy the legal requirement for just-and-reasonable rates in a regulated market.

The Risk Adder

In its most recent natural-gas rate case, Sierra Pacific Power Co. asked the Nevada Public Utilities Commission (PUC) to approve a risk-premium adder when estimating the ROE investors would demand before investing in the company. Sierra Pacific argued that it faced an unusually risky position in the near term due to factors such as rapid customer growth and projected increases in capital expenditures. The PUC said

the utility had failed to put forth any evidence that the premium adder is necessary for capital attraction. More to the point, the PUC noted that the company could not explain why it has been able to improve its credit rating from a "B" to a "BB" bond rating since the last rate case, when the current ROE of 10.25 percent did not include a risk-premium adder. Finally, the commission pointed to its own recent actions that would reduce risk perceived by investors in the near term, including:

- 1) Commission statements and orders that indicate the PUC is satisfied with the company's procurement strategy policies;
- 2) Regulatory changes that cause an annual review by the PUC of Sierra Pacific's annual energy supply plan, which informs the commission of short-term purchase plans and number trends, thus decreasing the likelihood of future disallowances;
- 3) Regulatory changes to allow utilities to file annually for two energy cost adjustments if necessary, which is helpful in avoiding large deferred energy balances; and
- 4) Regulatory changes and commission orders that allow for an equity premium adjustment to Sierra Pacific's ROE for construction projects that are deemed critical facilities. *Re Sierra Pacific Power Co., Docket Nos. 05-1005 et al., 248 PUR4th 364, April 27, 2006 (Nev. P.U.C.)*

An Investment-Bank Analysis

In a major rate case involving electric delivery services provided by Commonwealth Edison Co. (ComEd), a coalition of groups representing small consumers looked to recent valuations of utility assets conducted by investment banks to support a new approach to estimating a rate of return that would attract investors to utility stocks. (The recently terminated plan for a merger of ComEd parent, Exelon, and Public Service Enterprise Group [PSEG], a New Jersey company, provided current market data and an opening to pitch the novel approach.) Using this new method, the consumer groups suggested that investors would favor investment in ComEd so long as a 7.75 percent equity allowance was included in rates. The alliance of consumer groups had estimated ComEd's cost of equity by inference from the weighted average cost of capital (WACC) calculated by Morgan Stanley for the merger of Exelon and PSEG. All other parties to the Illinois Commerce Commission (ICC) case used complex financial models to gauge ROE requirements and came up with much higher estimates, including the utility's offered 11 percent, the 10.19 percent presented by the commission staff, and 9.9 percent favored by a large industrial users group.

Predictably, ComEd responded that the new method pre-

How We Conducted the Survey

For those readers unfamiliar with this long-standing feature, our return-on-equity survey is a sample of the major retail electric and natural-gas rate cases conducted by state regulators across the nation. The survey focuses on the statistical results of traditional rate proceedings, where regulators set a revenue requirement based on cost-of-service projections, including an allowance for rate of return on equity (ROE).

This year's survey covers cost-of-equity capital determinations by state public utility commissions between Sept. 1, 2005, through Sept. 1, 2006. Survey methodology remains similar to past years—requests for information on the results of recent rate proceedings were sent to both regulators and utility financial officials. Direct examination of the commission rate orders, when available, provides additional information.

The traditional cost-of-service rate case remains the most obvious source of information on how utility regulators view the issue of shareholder earnings requirements. Nevertheless, performance-based rate plans and cases involving periodic earnings reviews also contain findings about the appropriate return on equity for utilities and are reported herein. Explanatory notes accompany most entries, and citations are provided for orders published in *Public Utilities Reports, Fourth Series (PUR4th)*.—PSC

sented by consumer groups could not possibly be reasonable because the 7.75 percent ROE it produced is more than 100 basis points below any ROE recently approved in the United States.

The consumer groups explained that because the cost of common equity is not a directly observable number, regulatory commissions have had to rely on subjective models, such as the capital-asset pricing model and the discounted cash flow model, to estimate a utility's cost of common equity. The consumer parties argued that recent merger activity in the electric industry could provide more direct evidence on cost of equity, and a unique opportunity to move away from the complex financial models. With this in mind, the groups hired an expert to recommend a cost of common equity based on a review of electric utility stock valuations conducted by three leading investment banks—Morgan Stanley, JP Morgan, and Lehman Brothers—for the merger between Exelon and PSEG. According to the groups, the valuations done by the three investment banks are a far more reliable indicator of investor needs than the subjective models used to bridge evidentiary gaps "that arise because the level of return required to induce real investors to provide capital for the firm is not directly observable."

The ICC rejected the new approach, finding that while the

consumers had portrayed their method as more objective than standard models, it was impossible to know what assumptions were made by the investment bankers, and whether the result was appropriate in a regulated setting. The commission noted that the expert had relied on WACC figures published by the investment firms as the basis for the estimates. To back out the cost of equity from the investment bankers' WACC estimates, the expert first had to make numerous assumptions, the PUC found.

The commission said it could not determine if the investment bankers used the same approach when determining cost of debt, what mix of debt maturities they used, or if they

included short-term debt. Further, it is unclear whether the Morgan Stanley analysis was for Commonwealth Edison and PECO, a Pennsylvania-based affiliate, separately, or for the proposed combined entity. It also is not known if the investment bankers used the same capital structure or made the same assumptions regarding the treatment of transitional funding instruments, the ICC added. *Re Commonwealth Edison Co., No. 05-0597, 250 PUR 4th 161, July 26, 2006 (Ill. C.C.).* ☐

Phillip S. Cross is a legal editor for Public Utilities Fortnightly. Please address any questions about the survey to him at pcross@pur.com.

Company Name	Type of Service (Electric or Gas)	Case, Docket, Decision or Order No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
ARIZONA Southwest Gas Corp.	Gas	G-01551A 04-0716 247 PUR4th 243	12/9/04	2/23/06	8/31/04	66.9	49.35	11	9.5 ¹
ARKANSAS Arkansas Oklahoma Gas Corp.	Gas	05-006-U 246 PUR4th 228	2/01/05	12/01/05	8/31/04	6.886	NA	NA	9.7
Arkansas Western Gas Co.	Gas	04-176-U	12/29/04	10/31/05	1/31/06	9.7	4.6	9.9	9.7
CenterPoint Energy Arkla	Gas	04-121-U 245 PUR4th 384	11/24/04	9/19/05	4/30/04	27.9	[11.5]	NA	9.45 ²
CALIFORNIA Pacific Gas & Electric Co.	Electric	A.05-05-006 ³ D.05-12-043 245 PURth 492	6/16/05	12/15/05	12/31/06	NA	3.3	11.22	11.35
Pacific Gas & Electric Co.	Gas		6/16/05	12/15/05	12/31/06	NA	1.0	11.22	11.35
San Diego Gas & Electric Co.	Electric		6/16/05	12/15/05	12/31/06	NA	NA ⁴	10.38	10.79
San Diego Gas & Electric Co.	Gas		6/16/05	12/15/05	12/31/06	NA	NA	10.38	10.79
Southern California Edison Co.	Electric		6/16/05	12/15/05	12/31/06	NA	(26.4) ⁵	11.4	11.6
COLORADO Colorado Natural Gas, Inc.	Gas	055-412-G	8/31/05	3/01/06	3/31/05	0.9	0.8	15.0	12.0
Eastern Colorado Utility Co.	Gas	055-439G	9/23/05	5/15/06	12/31/04	0.16	0.07	12.9	10.5
Public Service Co. of Colorado	Gas	055-264G	5/27/05	2/03/06	12/31/04	33.4	22.5	11.0	10.5
FLORIDA Florida Power & Light Co.	Electric	05-0045-EI	3/22/05	9/15/05	12/31/06	930	NA ⁶	11.0	11.75 ⁷
Progress Energy Florida	Electric	050078-EI	4/29/05	9/28/05	12/31/06	206	NA	12.0	11.75 ⁷
GEORGIA Atmos Energy	Gas	20298-U	5/20/05	11/21/05	6/19/06	4.023	.345	11.5	10.12 ⁸
IDAH0 Idaho Power Co.	Electric	IPC-E-05-28	10/28/05	5/12/06	12/31/05	44	18.1	10.25	NA ⁸
ILLINOIS Commonwealth Edison Co.	Electric ⁹	05-0597 250 PUR4th 161 04-0779 245 PUR4th 194	8/31/05	6/26/06	12/31/04	34.5	8.331	11.72	10.04 ⁹
NICOR Gas Co.	Gas		11/04/04	09/20/05	12/31/05	83.3	49.7 ¹⁰	11.13	10.51
INDIANA Snow & Ogdon Gas Co., Inc.	Gas	42844	4/25/05	8/31/05	9/30/04	.211	.166	NA	9.76
Switzerland County Natural Gas Co., Inc.	Gas	42821-U	4/8/05	11/22/05	11/30/04	.0046	.0036	NA	10.5
IOWA Aquila	Gas	RPU-05-02	5/02/05	3/01/06	12/31/04	4.1	2.6	NA [*]	"

Company Name	Type of Service (Electric or Gas)	Case, Docket, Decision or Order No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
Interstate Power & Light Co.	Gas	RPU-05-1 245 PUR4th 171	4/15/05	10/14/05	12/31/04	19.07 ¹²	14.01	11.05	10.4
KANSAS									
Empire District Electric Co.	Electric	05-EPDE-980-RTS	4/29/05	12/09/05	12/31/04	4.18	2.15 ¹³	*	*
Kansas Gas & Electric Co.	Electric	05-WSEE-981-RTS	5/02/05	12/28/05	12/31/04	84.1	3.0 ¹⁴	11.02	10.0
KENTUCKY									
Kentucky Power Co.	Electric	2005-00341 248 PUR4th 38	8/26/05	3/14/06	6/30/05	64.796	46.0 ¹⁴	11.0	10.5
The Union Light Heat & Power Co.	Gas	2005-00042	2/25/05	12/22/05	9/30/06	14.048	8.091	11.0	10.2
LOUISIANA									
CLECO Power LLC	Electric	U-21496	12/05/05	7/28/06	NA ¹⁵	NA ¹⁵	NA ¹⁵	12.25	11.25
Entergy Gulf States	Electric	U-28916	NA	8/14/05	12/31/04	23.8	0	10.25	10.65
MAINE									
Maine Public Service Co.	Electric	2006-24	3/13/06	7/11/06	12/31/05	3.24	1.75	10.40	10.2
MARYLAND									
Baltimore Gas & Electric Co.	Gas	9036	4/29/05	12/21/05	7/31/05	52.6	35.6	11.05	11.0
MASSACHUSETTS									
Bay State Gas Co.	Gas	DTE-05-27	12/01/05	11/30/05	12/31/04	22.2	11.1	11.40	10.0
MICHIGAN									
Consumers Energy Co.	Electric	U-14347 246 PUR4th 177	12/14/04	12/22/05	12/31/06	319.7	86.1 ¹⁶	12.25	11.15
Detroit Edison Co.	Electric	U-14838	6/01/06	8/31/06	NA	45	[78.25]	11.0	11.0
Upper Peninsula Power Co.	Electric	U-14745	1/03/06	6/27/06	12/31/06	6.6	3.8	11.4	10.75
MINNESOTA									
Interstate Power & Light Co.	Electric	E-001/GE-05-748	5/16/05	3/03/06	12/31/04	4.8	1.2	11.25	10.39
Northern States Power Co.	Electric	E-002-GR-05-1428	11/02/05	9/01/06	12/31/06	168.0	131.5 ¹⁷	11.47	10.54
NEVADA									
Sierra Pacific Power Co.	Electric	05-10003	10/03/05	4/27/06	5/31/05	3	(14)	10.25	10.6
Sierra Pacific Power Co.	Gas	05-10005 248 PUR4th 364	10/03/05	4/27/06	5/31/05	8	4.5	8.7	10.6 ¹⁸
NEW JERSEY									
Jersey Central Power & Light Co.	Electric	ER02080506	NA	5/31/05	12/31/05	[42]	[164]	12.2	9.55
NEW YORK									
Conning Natural Gas Corp.	Gas ¹⁹	05-G-1359 249 PUR4th 209	10/31/05	5/22/06	12/31/05	3.46	2.7 ²⁰	10.7	10.0 ²¹
NORTH DAKOTA									
Xcel Energy	Gas	PU-04-578	11/04/04	6/01/05	12/31/04	1.3	.750	11.5	*
OHIO									
Cincinnati Gas & Electric Co.	Electric	05-0059-EL-AIR	2/17/05	12/21/05	6/30/05	77.945	51.493	12.025	10.29
OKLAHOMA									
Oklahoma Gas & Electric Co.	Electric	PUD20050015	5/20/05	12/12/05	12/31/04	89.065	42.306	*	10.75
OREGON									
Pacific Power & Light Co.	Electric	UE 170 Order No. 05-150 244 PURth 1	11/12/04	9/28/05	12/31/06	102	26	10.5	10.0 ²²
SOUTH CAROLINA									
South Carolina Electric & Gas Co.	Gas	2005-113-G	4/26/05	11/01/05	12/31/04	28.5	22.9	12.25	10.25
VIRGINIA									
Virginia Natural Gas Co.	Gas	PUE-2005-00057 250 PUR4th 421	NA ²³	7/24/06	NA	NA	9.8 ²⁴	NA	10.0
WASHINGTON									
Avista Corp.	Electric	UE-050482	3/30/05	12/21/05	12/31/04	35.8	22.135	11.16	10.4
Avista Corp.	Gas	UG-050483	3/30/05	12/21/05	12/31/04	2.9	.968	11.16	10.4
WISCONSIN									
Madison Gas & Electric Co.	Electric	3270-UR-114	4/19/05	12/12/05	12/31/06	37.9	35.9	11.5	11.0
Madison Gas & Electric Co.	Gas	3270-UR-114	4/19/05	12/12/05	12/31/06	4.0	3.8	11.5	11.0
Northern States Power Co. — Wisconsin	Electric	4220-UR-114	6/01/05	1/05/05	12/31/06	61.4	43.4	11.9	11.0

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Northern States Power Co. — Wisconsin	Gas	4220-UR-114	6/01/05	1/05/05	12/31/06	8.1	3.9	11.9	11.0
Wisconsin Electric Power Co.	Electric	05-UR-102	7/01/05	1/26/06	12/31/06	256.4 ²⁵	229.7	12.2	11.2
Wisconsin Electric Power Co.	Gas	05-UR-102	6/01/05	1/26/06	12/31/06	27.4	21.4	12.2	11.2
Wisconsin Gas LLC	Gas	05-UR-102	6/01/05	1/26/06	12/31/06	53.2	38.7	11.8	11.2
Wisconsin Public Service Corp.	Electric	6690-UR-107	4/01/05	12/22/05	12/31/06	134.0	79.9	11.5	11.0
Wisconsin Public Service Corp.	Gas	6690-UR-117	4/01/05	12/22/05	12/31/06	10.0	7.2	11.5	11.0

ENDNOTES

* Settlement agreement. No ROE figure stated.

- ROE figure shown includes a 30 basis-point upward adjustment to account for LDC's higher risk when compared to financial study proxy group.
- Adopted ROE set below the normally accepted mid-point range to reflect finding that LCD had been deficient in accounting and record keeping practices, and had exhibited a pattern of inadequate customer service.
- Order adopting rate-making cost of capital for major investor-owned energy utilities.
- Approved overall rate of return 5 basis points higher than last authorized rate. Produces only nominal change in revenue requirement.
- Although allowed ROE is 20 basis points higher than prior year's award, rate reduction results from lower approved figures for cost of debt and preferred stock.
- Revenue sharing agreement settlement. Existing rates remain in place. Retail base-rate revenues between specified threshold amounts will be shared 2/3 to ratepayers and 1/3 to shareholders. No ROE specified in revenue-sharing settlement.
- Figure shown is current ROE for recovery clause calculations and other non-base-rate purposes.
- Stipulated overall rate of return of 8.1%. No ROE given.
- Delivery service only.
- Final figure per order on rehearing issued 05/28/06. Initial order included an increase of \$45.6 million.
- Settlement agreement. No ROE figure provided. Overall rate of return listed as 8.879%.
- Settlement agreement includes ROE as shown.
- Figure shown includes adjustment for initiation of fuel adjustment charge rate.
- Approved settlement provides that \$28.106 million in environmental surcharge costs will be removed from adjustment clause filing and incorporated into base rates.
- Order on periodic earnings review under existing rate stabilization plan. Threshold for earnings sharing lowered from current ROE of 12.25% to 11.25%.
- Commission finds stranded cost recovery complete. Figure shown allows full recovery of production fixed costs on a going-forward basis.
- Figure shown is Phase 1 grant. Phase 2 grant totaling an additional \$114.9 million revenue requirement effective 1/1/07.
- Commission rejects proposed risk-premium adder as unwarranted given LDC's improved credit rating and recent regulatory actions limiting risk such as preapproval of energy supply plans and ROE premiums for large construction projects.
- Delivery service rates.
- Revenue award includes credit of \$1.4 million in allegedly unreasonable gas commodity costs recovered from ratepayers in 2005-2006 heating season.
- Per settlement proposal. Commission finds revenue figure reflects amount the LDC requires to operate and maintain its gas distribution system.
- Figure as listed in approved settlement agreement.
- In July 14, 2005, order for notice and hearing the commission consolidated utility's rate-case filing and application for performance-based rate plan. Utility may decline commission-approved performance plans, in which case rates may be reset based on cost-of-service data.
- Order approving performance-base rate plan. Commission rejects proposal to dismiss general rate filings and approves revenue requirement findings as shown to be used in event utility rejects plan.
- Financial data indicated the need for a \$393.9 million increase, but WEPCO only requested an increase of \$256.4 million based on the recovery of: \$67.5 million in costs related to transmission charges; \$70.1/million related to reliability investments; \$6 million in costs related to renewable sources of energy; \$93.4 million in additional fuel costs; and \$19.4 million related to Midwest Independent Transmission System Operator additional costs.

Energy Risk Management
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by Andrew S. Hodge

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Annual ROE Survey

Capitalizing On Grid Concerns



BY PHILLIP S. CROSS

Regulators use rate cases to craft incentives for capital spending.

A new trend has evolved in utility rate cases. In the past year, state utility regulators have begun tailoring return-on-equity (ROE) rate allowance to encourage utilities to build infrastructure.

Traditional ROE analysis focuses on the utility's ability to attract sufficient capital to make the investments necessary for providing adequate service. Generally speaking, rate regulators leave the timing and choice of such investment to utility managers. But some current cases show an increasing willingness to give managers an earnings incentive to pursue preferred investments.

Federal regulators have made some high-profile moves in this direction in recent years. FERC recently ruled an investment by an electric utility in a transmission expansion project for Western Pennsylvania is eligible for significant levels of ROE incentives.¹ In that case, the commission found Duquesne Light Co. was under no absolute mandate to make the upgrades and had voluntarily chosen to invest in an important reliability project that would benefit consumers.

The ruling allows Duquesne to earn returns as high as 13.8 percent on the investment. A look at the company's returns reported this year indicates what a good deal this is for investors.

The idea the ROE allowance might be adjusted to make sure utilities can attract adequate capital is not new to state regulators. This year, however, several states have looked beyond the traditional base-rate proceeding to exploit the ROE component of regulated rates as a tool to improve energy system reliability and efficiency. A recent resource-planning case involving Nevada's electric utilities provides an example.² (The proceeding wasn't a rate case [and therefore does not appear in the accompanying chart], but rather an integrated resource planning (IRP) proceeding.)

According to the Nevada Public Service Commission (PSC), the state faces a number of challenges in meeting its long-term electricity needs. The PSC says the state's major utilities have forecasted a need for significant new power supply, with a real possibility of shortages in the near term. Additionally, the utilities rely on purchased power to meet a large part of their load requirements. After reviewing the utilities' preferred resource plans, the commission concluded the public would gain maximum benefit if the utilities build and own a new large power plant.

The Nevada PSC also identified a clean-coal option as the best choice for the state's consumers, rather than relying on a gas-fired power plant that would be cheaper to build, but often more expensive to run. The commission said the utilities should be encouraged to invest in more renewable energy to add needed diversity to the generation mix.

To make this happen, the PSC granted Nevada Power Co. and Sierra Pacific Power Co. several "equity adders" ranging from 0.125 percent to 0.25 percent for hitting or exceeding solar and non-solar renewable targets, as well as for completing the requested clean-coal plant by 2012.

Decoupling Dance

Estimating an appropriate rate of return on equity for utility investors is a fundamental component of the cost-of-service rate case conducted across the nation by state energy utility regulators. The following survey (*see chart*) demonstrates the results of those proceedings over the past year. As usual, current interest rate trends and a discussion of business risk dominate the debate; market restructuring efforts either wind down or mature; and discussion of the effect of such programs on ROE in traditional rate proceedings seems to be on the wane. In addition to the idea the ROE rate component is an appro-

ROE SURVEY METHODOLOGY

Fortnightly's annual return-on-equity (ROE) survey is a sample of major retail electric and natural-gas rate cases conducted by state regulators across the United States. The survey is focused on the statistical results of traditional rate proceedings, in which regulators set a revenue requirement based on cost-of-service projections, including an ROE-rate allowance.

This year's survey covers cost of equity capital determinations by state PUCs during the period Sept. 1, 2006 through Aug. 31, 2007. Survey methodology remains similar to *Fortnightly* ROE surveys from past years—requests for information on the results of recent rate proceedings were sent to both regulators and utility financial officials. In addition, direct examination of the commission rate orders, when available, provides additional information.

Traditional cost-of-service rate cases remain the primary source of information on how utility regulators view the issue of shareholder earnings requirements. Nevertheless, performance-based rate plans and cases reviewing periodic earnings also contain findings about the appropriate ROE for utilities, and therefore are included in the survey. Explanatory notes accompany most entries, and citations are provided for orders published in *Public Utilities Reports, Fourth Series (PUR4th)*.—PC

priate tool to signal investment preferences as discussed above, regulators at the state level also are beginning to focus on the effect their own more traditional regulatory methods and procedures might have on a utility's risk profile.

One example of this is seen in an electric rate case decided by the Idaho PUC.³ In that case, the PUC authorized Idaho Power Co. to implement a three-year, fixed-cost decoupling pilot program. The mechanism adjusts rates upward or downward to recover the company's fixed cost of service independent from the volume of the utility's energy sales. With such a plan, a utility collects a stable revenue stream whether or not its customers respond to conservation incentives in a positive way. (For example, if sales go down due to efficiency improvements or conservations, rates will go up within a 3 percent cap under the approved plan.)

After setting a revenue requirement and a new ROE for the coming rate period, the commission put the utility on notice that it would address in a future rate case whether it should reduce the company's authorized ROE to reflect reduced risk of cost recovery under the new adjustment mechanism. ■

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Endnotes

1. *Re Duquesne Light Co.*, FERC Docket Nos. EL06-109-000 et al., Feb. 6, 2007.
2. *Re Nevada Power Co.*, 253 *PUR4th* 252 (Nev. P.S.C. 2006).
3. *Re Idaho Power Co.*, 256 *PUR4th* 322 (Idaho PUC 2007).

Company Name	Type of Service (Electric or Gas)	Case, Docket, or Decision No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
ARIZONA									
Arizona Public Service Co.	Electric	69663 258 PUR4th 353	11/4/05	6/28/07	9/30/05	425.847	321.7	10.25	10.75*
ARKANSAS									
Arkansas Western Gas Co.	Gas	06-124-U	9/25/06	7/13/07	10/31/06	13.1	5.8	9.7	9.5
Entergy Arkansas Inc.	Electric	06-101-U 258 PUR4th 1	8/15/06	6/15/07	6/30/06	106.5	(5.67)	11.0	9.9 ¹
Oklahoma Gas & Electric Co.	Electric	06-070-U 255 PUR4th 393	7/28/06	1/5/07	12/31/05	13.5	5.4	10.3	10.0 ²
COLORADO									
Colorado Natural Gas	Gas	06S-394G	7/5/06	2/22/07	3/31/06	3.9	2.49	12.0	12.0
Public Service Co. of Colorado	Electric	06S-234EG	4/14/06	12/1/06	12/31/05	178	107	10.75	10.5
Public Service Co. of Colorado	Gas	06S-656G 258 PUR4th 185	12/1/06	7/3/07	6/31/06	41.5	32.3	10.5	10.25
CONNECTICUT									
Connecticut Natural Gas Co.	Gas	06-03-04PH01	9/29/06	3/14/07	6/06	37.1	25.7	10.8	10.1
Yankee Gas Service Co.	Gas	06-12-02PH01 259 PUR4th 142	12/29/06	6/29/07	12/31/06	44.2 ³	22.1 ³	9.9	10.1 ⁴
ILLINOIS									
AmerenCILCO	Electric	06-0070 et al.	12/27/05	11/21/06	12/31/04	43	21	11.02	10.12
AmerenCIPS	Electric	06-0070 et al.	12/27/05	11/21/06	12/31/04	14	-8	11.35	10.08
AmerenIP	Electric	06-0070 et al.	12/27/05	11/21/06	12/31/04	145	84	11.89	10.08
INDIANA									
Lawrenceburg Gas Co.	Gas	43090	7/28/06	6/20/07	4/30/05	2.114	1.330	NA	8.84
Southern Indiana Gas & E. Co.	Gas	43112	9/1/06	8/1/07	3/31/06	10.436	5.130	NA	10.15
Southern Indiana Gas & E. Co.	Electric	43111	9/1/06	8/15/07	3/31/06	90.410	67.255	NA	10.4
KANSAS									
Aquila-Kansas Gas Network	Gas	07-AQLG-431-RTS	11/1/06	5/16/07	6/30/06	7.2	5.1	*	*
Kansas City Power & Light	Electric	06-KCPE-828-RTS	1/31/06	12/4/06	12/31/05	42.3	29	*	*
Kansas Gas Service Co. Div. of OneOK	Gas	06-KGSG-1209-RTS	5/15/06	11/16/06	12/31/05	73.3	52.0	*	*
KENTUCKY									
Columbia Gas of Kentucky	Gas	2007-00008	2/19/07	8/29/07	9/30/06	12.646	7.25	*	10.5 ⁵
Duke Energy Kentucky	Electric	2006-00172	5/31/06	12/21/06	12/31/07	66.6	49	11.5	*
LOUISIANA									
Cleco Power ILC	Electric	U-21496-J	3/30/07	NA	9/30/06	NA ⁶	NA ⁶	11.25 ⁶	11.25 ⁶
MARYLAND									
Delmarva Power & Light Co.	Electric	9093	11/17/06	7/19/07	9/30/06	20.333	14.882	14.75 ⁸	10.0
The Potomac Electric Power Co.	Electric	9092 258 PUR4th 463	11/17/06	7/19/07	9/30/06	55.7	10.61	12.75 ⁷	10.0
MASSACHUSETTS									
Fitchburg Gas & Electric Light Co.	Gas	DTE 06-109	11/29/06	1/26/07	12/31/05	3.961	1.2 ⁹	10.0	10.0
MICHIGAN									
Consumers Energy	Gas	U-14547 253 PUR4th 477	6/1/05	11/21/06	12/31/04	132.4	80.804 ¹⁰	11.4	11.0
Consumers Energy Co.	Gas	U-15190	2/9/07	8/21/07	"	88.3	49.75	11.0	10.75 ¹¹
MINNESOTA									
Center Point Energy	Gas	G008/GR-05-1380 254 PUR4th 23	11/2/05	11/2/06	12/31/06	40.88	20.96	10.18	9.71
Northern States Power Co.	Gas	G002/GR-06-1429	11/9/06	9/10/07	12/31/07	18.5	11.9	10.4	9.71
MISSOURI									
AmerenUE	Electric	ER-2007-002 259 PUR4th 259	7/7/06	5/22/07	6/30/06	361	43	*	10.2
AmerenUE	Gas	GR-2007-0003	7/7/06	3/15/07	6/30/06	11	6	*	*
Aquila Inc.	Electric	ER-2007-0004	7/3/06	5/31/07	12/31/06	118.9 ¹²	58.8	NA	10.25

Company Name	Type of Service (Electric or Gas)	Case, Docket, or Decision No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
		257 PUR4th 424							
Kansas City Power & Light Co.	Electric	EO-2006-0391	2/1/06	12/21/06	12/31/05	57	50.6	12.5	11.25
Missouri Gas Energy, a Division of Southern Union Co.	Gas	GR-2006-0422 256 PUR4th 250	5/1/06	3/22/07	12/31/05	41.7	27.2	10.5	10.5 ¹⁹
NEBRASKA Aquila Inc.	Gas	NG-0041	11/15/06	7/24/07	6/30/06	16.3	9.2		10.4
NEW HAMPSHIRE Unitil Energy Systems Inc.	Electric	DE 05-178	11/4/05	10/6/06	6/30/05	4.65	2.267 ¹⁴	9.67	9.67
NEW JERSEY Public Service Electric & Gas Co.	Gas	GR05100845	9/30/05	11/9/06	9/30/05	132.8	40.015	10.0	10.0
NEW MEXICO El Paso Electric Co.	Electric	06-00258	6/30/06	7/3/07	12/31/05	13.100	5.800		
Public Service Co. of New Mexico	Gas	06-00210	5/30/06	6/29/07	12/31/05	21.305	9.362		9.53
NEW YORK Central Hudson Gas & Corp. Electric	Electric	05-E-0934	7/29/05	7/24/06	3/31/05	52.8 ¹⁵	41.4 ¹⁵	10.6	9.6 ¹⁷
Central Hudson Gas & Electric Corp.	Gas	05-G-0935 251 PUR4th 20	7/29/05	7/24/06	3/31/05	18.1 ¹⁵	8 ¹⁵	10.6	9.6 ¹⁷
Orange & Rockland Utilities Inc.	Gas	05-G-1494 252 PUR4th 351	11/28/05	10/20/06	10/31/07	23.7 ¹⁵	6.5 ¹⁵	NA	9.8 ¹⁶
NORTH DAKOTA Xcel Energy	Gas	PU-06-525	12/15/06	6/13/07	12/31/07	2.8	2.2	11.5	10.5
OREGON Cascade Natural Gas	Gas	UG 173 Order No. 07-07-220	2/15/07	6/5/07	9/30/05	NA	(0.7)	12.25	10.1
Pacific Power & Light Co.	Electric	UE 179 Order No. 06-530	2/23/06	1/1/07	12/31/07	112	43	10.0	10.0
Portland General Electric	Electric	UE 180 Order No. 07-065 254 PUR4th 349	3/15/06	1/12/07	12/31/07	25	(21) ¹⁸	10.5	10.1
PENNSYLVANIA National Fuel Gas Distribution Corp.	Gas	R-00061493	5/31/06	1/1/07	12/31/06	25.9	14.3	*	*
PPL Gas Utilities Corp.	Gas	R-00061398 255 PUR4th 209	3/27/06	2/8/07	12/31/06	12.813	8.142	NA	10.4
SOUTH CAROLINA Lockhart Power Co.	Electric	2007-33-E	2/5/07	7/19/07	12/31/05	0.593	0.484*	11.75 ¹⁹	12.0 ²⁰
SOUTH DAKOTA Black Hills Power	Electric	EI-06-019	6/30/06	12/29/06	12/31/05	9.594	7.972	*	*
TENNESSEE Atmos Energy Corp.	Gas	05-00258	²¹	²²	9/30/07	²³	(6.1)	NA	10.48
Chattanooga Gas Co.	Gas	06-00175	6/30/06	²²	12/31/07	5.8	2.8	10.2	10.2
UTAH PacifiCorp	Electric	06-035-21 254 PUR4th 285	3/7/06	12/1/06	9/30/07	197.2	115 ²⁴	10.5	10.25 ²⁵
VERMONT Green Mountain Power Co.	Electric	7175/7176	4/19/06	12/22/06	12/31/05	24.999	20.043	10.5	10.25
VIRGINIA Appalachian Power Co.	Electric	PUE-2005-00056 ²⁶	7/1/05	11/20/06	6/30/04 ²⁷	62.1	21.3	NA	9.8 ²⁸
Columbia Gas of Virginia	Gas	PUE-2005-00098 255 PUR4th 1	11/2/05	12/28/06	NA	²⁹	²⁹	—	10.5 ³⁰
WASHINGTON PacifiCorp	Electric	UE-060817 257 PUR4th 380	10/3/06	6/21/07	3/31/06	23.2	14.189	10.2	10.2

Company Name	Type of Service (Electric or Gas)	Case, Docket, or Decision No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
Puget Sound Energy	Electric	UE-060266	2/15/06	1/5/07	9/30/05	33.779	17.174 ³¹	10.3	10.4
Puget Sound Energy	Gas	UG-060267 255 PUR4th 287	2/15/06	1/5/07	9/30/05	39.008	31.29	10.3	10.4
WEST VIRGINIA									
Monongahela Power Co. and The Potomac Edison Co. ³²	Electric	06-0960-E-42T 257 PUR4th 186	7/26/06	5/22/07	12/31/05	99.8	(6.2)	10.85	10.5
WISCONSIN									
Superior Water, Light & Power Co.	Electric	5820-UR-110 254 PUR4th 142	5/1/06	12/22/06	12/31/07	3.33 ³³	1.72 ³³		11.1 ³⁴
Superior Water, Light & Power Co.	Gas	5820-UR-110 254 PUR4th 142	5/1/06	12/22/06	12/31/07	3.33	1.72		11.1
Wisconsin Power & Light Co.	Electric	6680-UR-115	3/17/06	1/19/07	12/31/07	87.6	36 ³⁵	11.5	10.8
Wisconsin Power & Light Co.	Gas	6680-UR-115	3/17/06	1/19/07	12/31/07	8.7	(1.9)	11.5	10.8
Wisconsin Public Service Corp.	Electric	6690-UR-118	3/31/06	1/12/07	2007	125.1	56.7	11.0	10.9
Wisconsin Public Service Corp.	Gas	6690-UR-118	3/31/06	1/12/07	2007	22.6	18.9	11.0	10.9

ENDNOTES

* Settlement agreement. No ROE figure stated.

- Figure reflects finding by commission that utility collects 40 percent of retail revenues through adjustment clause, making it less risky than other comparable utility companies.
- Revenue settlement reflects cost of equity as shown.
- Revenue shown is after LNG mitigation.
- Revenue settlement includes earnings-sharing mechanism, which provides for allocation to ratepayers of 100 percent of all earnings above figure shown.
- Settlement stated ROE. Previous case was settled with no stated ROE.
- Order on periodic earnings review under existing rate-stabilization plan. Figure shown is threshold for earnings sharing.
- The last case involving this utility where the cost of equity is noted resulted in a final order issued May 1991. Four rate cases filed since that date were determined by settlement agreements that did not specify any element of the cost of capital.
- The last case involving this utility where the cost of equity was noted resulted in a final order issued December 1984. Six rate investigations filed since that date were determined by settlements, which did not specify any element of the cost of capital.
- An additional \$1 million increase to become effective Nov. 1, 2007.
- In addition to revenue increase shown, utility is authorized to make permanent a two-year \$58.1 million increase approved by order dated Oct. 14, 2004.
- Partial settlement agreement includes ROE + Revenue figures.
- Figures shown is total system-wide increase for L&P operating division is \$45.1 million. Increase for MPS operating division is \$13.6 million.
- ROE figure shown reflects downward adjustment of 32.5 basis points for reduced risk associated with approved a straight fixed-variable rate design.
- An additional \$358,853 increase effective Nov. 1, 2006; additional \$107,475 effective May 1, 2007.
- First year of three-year revenue settlement agreement.
- Earnings sharing component of rate plan triggered if utility achieves 11 percent ROE, reduced to 10.8 percent if company fails to earn "retail customer choice education incentive."
- Earnings sharing component of rate plan triggered if utility achieves 10.6 percent ROE.
- Rate orders address two filings. The first, a general rate increase application resulted in rate decrease shown. The second, a request to recover costs of a new generating plant, produced an increase of \$42.1 million, effective when plant comes on line.
- Order set a range of 11.25 to 11.75 percent with rates set using 11.70 percent figure.
- Settlement Agreement includes ROE as shown.
- On 9/16/05 the Consumer Advocate Division petitioned the Tennessee Regulatory Authority (TRA) to open an investigation to determine whether Atmos Energy Corp. was overearning.
- Final order pending.
- After an investigation by TRA staff and then a contested case proceeding, the TRA determined on 10/26/06 that Atmos had a revenue surplus of \$6.1 million for the 12 months ending 9/30/07.
- Increase shown is subject to a \$30 million rate credit. Net of credit, rates increase by \$85 million effective 12/11/06 and by an additional \$30 million on 6/1/07.
- Revenue settlement reflects ROE as shown.
- Application to adjust capped rates to recover prudently incurred incremental environmental and reliability costs.
- Base period for calculating incremental investment.
- Figure shown reflects current financial conditions. Applicable only as "carry charge" on incremental costs determined in current case.
- Commission adopts stipulated performance-based rate plan. Rates frozen of current levels for 5 years beginning Jan. 1, 2006.
- Stipulated performance-based rate plan provides that utility will share earnings over figure shown 75 percent to ratepayers 25 percent to shareholders.
- Final revenue figure subject to adjustment for calculation of power costs.
- Joint application. Both companies constitute a single utility system with the same rates and power supply source.
- Figure shown is total of electric, gas & water operations:
\$797 million approved electric increase.
\$347 million approved gas increase.
\$548 million approved water increase.
- ROE award applied to 55 percent common equity finance ratio.
- Revenue award includes cost of fuel.

Commission Watch

2008 ROE Survey

Rates, Risks & Regulators

Economic uncertainties raise doubts about utility returns.

BY PHILLIP S. CROSS

Recent shocking and unprecedented news in financial markets brings to mind several questions about utility rate cases and authorized returns. Given that utility regulators rely on financial models when seeking to determine the cost of capital for a utility, one might ask what effect stock prices and interest rates will have on the process. Will regulators feel a need to consider broader economic effects when engaging in a process that is often closely watched by the investment community?

In this time of economic uncertainty, utility investors are reminded that authorized return on equity (ROE) allowances aren't actual earnings, but rather the rates utilities and regulators use to determine how much money consumers must pay to make it possible for the utility to earn a reasonable profit and to attract investors in the future. As such, the award is not a guarantee. To earn the ROE set by a commission, the utility must keep future expenses and sales at or near the levels as during a 12-month proxy period known as the "test year."

In extraordinary times like these, regulators should expect some extraordinary testimony from the financial experts who appear as witnesses in rate cases.

The Ratemaking Formula

Reported here are results of *Fortnightly's* annual survey of utility rate cases. The survey, which reports the statistical results of traditional rate proceedings, provides a sample of major retail electric and natural gas rate cases conducted by state regulators across the nation. (And this year, for comparison, we included several Ontario rate cases.)

When setting rates, regulators gather information about what it will cost the utility to run the company, including

operating expense, taxes and depreciation, short and long-term borrowing, plus the fair return on investment. To arrive at an amount of money to be collected from ratepayers for the return component of rates, the value of the company's property, or rate base, is calculated and the ROE rate is applied to that figure. The resulting number of dollars is then added to the cost-of-service ratemaking formula to arrive at a total revenue requirement for the utility.

Given this, it's easy to understand why the ROE part of a rate case often is the most contentious. First, while expenses and other costs might be determined with some level of certainty, the amount of profit that's considered "fair" certainly is subject to debate.

Additionally, the second part of the issue—what level of return is necessary

to attract investment in the company and provide incentives for managers to make business decisions that benefit consumers—also is a question tailor-made for debate, and for analysis by financial consultants and attorneys.

In a case reported in this year's ROE survey, the Wisconsin Public Service Commission (PSC) discussed the distinction between the "bare-bones" cost of capital, as revealed by statistical models, and the appropriate ROE award for ratemaking purposes. The PSC explained one view: The cost of equity represents the target for the return on equity. According to this perspective, financial-model results are the central focus, and absent extraordinary circumstances, the regulator should set the ROE at its best estimate of the utility's cost of equity.

An opposing view also was offered by the PSC: The cost of equity is just one of several factors that direct a regulatory body toward the proper ROE. In this view, during normal economic times, the financial models provide estimates as to the minimum acceptable return, and not necessarily the fair return. The fair return, under this method, typically lies above the cost of equity.

The Wisconsin PSC chose the latter view, explaining that the cost of equity represents the starting point in the ROE analysis, and in most cases does not represent the target rate of return for ratemaking. The PSC said setting the return on equity at the cost of equity, by definition, is a minimalist policy that would allow the utility barely to compete for capital. [See *Re Northern States Power Co., Wisconsin*, 264 PUR4th 236, No. 4220-UR-115, Jan. 8, 2008 (Wis. P.S.C.).]

Stock Prices and Interest Rates

Stock prices and interest rates are fundamental inputs in models used in setting ROE awards. Interest rates frequently are cited as a benchmark. The so-called "risk-free rate" readily is observable in the »

In extraordinary times like these, regulators should expect some extraordinary testimony.

market for government securities. The base rate is identified for the test period under review and a premium above that amount is chosen that represents the increase necessary to cover additional risk associated with stocks and to attract utility stock investors. If rates for government securities are low, many would argue that ROE awards should follow.

Another example of how changes in interest rates might affect ROE awards is found in a recent decision by the California Public Utilities Commission (PUC). In that case, the PUC adopted a new, multi-year cost-of-capital mechanism (CCM) for the major California energy utilities. Under the new plan, the costs of capital used in setting rates for the utility companies—*i.e.*, costs for long-term debt, preferred stock and common equity—will be set every three years in a full cost-of-capital proceeding. However, changes in interest rates that occur outside of a 100-basis point deadband under

a 12-month measurement period would trigger adjustments to the capital cost rates of the utilities. [See *Re Southern California Edison Co.*, 265 PUR 4th 161, D. 08-05-035, (Cal. P.U.C. 2008).]

As for stock prices, a review of this year's rate cases shows the discounted-cash-flow (DCF) method remains the gold standard for financial modeling of utility cost of capital. (Other methods that directly assess the cost of risk-free investments also are used.) The DCF method uses as input the stock prices and dividend payments of companies with comparable risk. The most recent stock price is the one used when calculating dividend yield and growth rates under the DCF. As described in Dr. Roger Morin's text on utility cost of capital, *The New Regulatory Finance*:

Conceptually, the stock price to employ is the current price of the security at the time of estimating the cost of equity, rather than

some historical high-low or weighted average stock price over an arbitrary historical time period. The reason is that the analyst is attempting to determine a utility's cost of equity in the future, and since current stock prices provide a better indication of expected future prices than any other price [t]he most relevant stock price is the most recent one.... Use of any other price violates market efficiency.

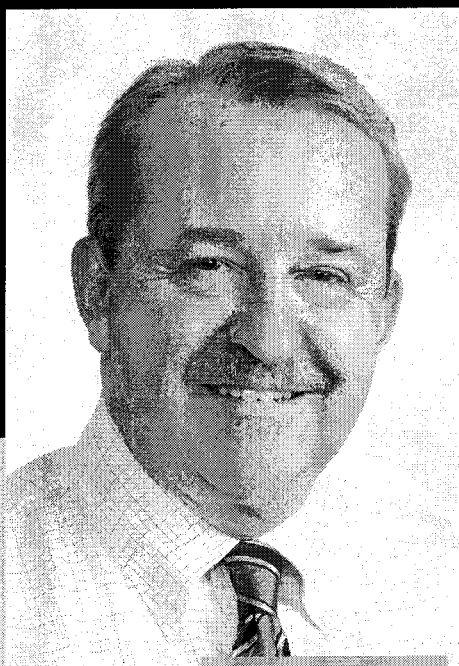
In rate cases to come over the next year, the drop in stock prices will have a major effect on the debate. It remains to be seen how the experts and the commissions will explain the role of the models in the process and the hard decisions that must be made to keep utilities financially sound. ■

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Company Name	Type of Service (Electric or Gas)	Case, Docket, or Decision No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
ALABAMA									
Alabama Gas Corp. ¹	Gas	18046 & 18328 262 PUR4th 556	— ²	12/21/07	12/31/07	—	— ²	13.75	13.75 ³
ARIZONA									
UNS Electric Corp.	Electric	E-04204A-06-0783	12/15/06	5/27/08	6/30/06	8.47	4.02	NA	10.0 ⁴
ARKANSAS									
Arkansas Oklahoma Gas Corp.	Gas	07-026-U	3/8/07	11/20/07	2/28/07	5.1	3.3	9.7	9.9 ⁵
CenterPoint Energy Arkansas Gas	Gas	06-161-U 261 PUR4th 107	1/16/07	10/25/07	12/31/06	0.9	20	9.45	9.65 ⁶
CALIFORNIA									
Pacific Gas & Electric Co.	Gas + Electric	D.07-12-049 ⁶ 262 PUR4th 53	6/14/07	12/20/07 ⁷	12/31/08	NA	0	11.35	11.35
San Diego Gas & Electric Co.	Gas + Electric	D.07-12-049	6/14/07	12/20/07	12/31/08	NA	9.6	10.79	11.10
Southern California Edison Co.	Electric	D.07-12-049	6/14/07	12/20/07	12/31/08	NA	(9.6)	11.40	11.50
COLORADO									
Source Gas Distribution, LLC	Gas	085-108G	3/4/08	8/7/08	8/31/07	17.74	14.86	NA	10.25
CONNECTICUT									
Connecticut Light & Power Co.	Electric	07-07-01	7/30/07	1/28/08	12/31/06	203.9	97.9	9.85	9.4
Connecticut Natural Gas Corp.	Gas	D.08-06-10 267 PUR4th 81	6/17/08	8/6/08	4/30/08	— ⁸	[15.5] ⁸	10.1 ⁹	10.1 ¹⁰
Northeast Utilities	Electric	07-07-01	7/30/07	1/28/08	12/31/06	189	77.8	9.85	9.40

Company Name	Type of Service (Electric or Gas)	Case, Docket, or Decision No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
DISTRICT OF COLUMBIA									
Potomac Electric Power Co.	Electric	F.C. 1053 Order 14712 263 PUR4th 1	12/12/06	1/30/08	9/30/06	47.9	28.3	11.1	10.0
Washington Gas Light Co.	Gas	F.C. 1054 Order 14694 262 PUR4th 360	12/21/06	12/28/07	6/30/06	20.0	1.4	10.6	— ¹¹
FLORIDA									
Florida Public Utilities Co.	Electric	070304-EI	8/30/07	5/19/08	12/31/08	5.25	3.85	11.5	11.0
St. Joe Natural Gas Co.	Gas	070592-GU	12/21/07	7/8/08	12/31/08	.627	.543	11.5	11.0
HAWAII									
Hawaiian Electric Co., Inc.	Electric	04-0113 24171 265 PUR4th 240	11/12/04	5/1/08	12/31/05	63.0 ¹²	44.9	11.4	10.7
IDAHO									
PacifiCorp dba Rocky Mountain Power	Electric	PAC-E-07-05 Order No. 30482	6/8/07	12/27/07	NA	18.5	11.5	NA	10.2
ILLINOIS									
Ameren CILCO	Electric	07-0585 <i>et al.</i>	11/2/07	9/24/08	12/31/06	10.1	(2.8)	10.1	10.65
Ameren CIPS	Electric	07-0585 <i>et al.</i>	11/2/07	9/24/08	12/31/06	30.8	22.0	10.08	10.65
Ameren CIPS	Gas	07-0585 <i>et al.</i>	11/2/07	9/24/08	12/31/06	14.4	7.6	10.7	10.68
Ameren CILCO	Gas	07-0585 <i>et al.</i>	11/2/07	9/24/08	12/31/06	(3.8)	(9.2)	10.5	10.68
Ameren IP	Electric	07-0585 <i>et al.</i>	11/2/07	9/24/08	12/31/06	139.3	103.9	10.08	10.65
Ameren IP	Gas	07-0585 <i>et al.</i>	11/2/07	9/24/08	12/31/06	55.9	39.8	10.0	10.68
Commonwealth Edison Co.	Electric	07-0566	10/17/07	9/10/08	12/31/06	362.3	273	11.7	10.3
North Shore Gas Co.	Gas	07-0241	3/9/07	2/5/08	9/30/06	6.3	(0.2)	11.3	10.0
Peoples Gas Light & Coke	Gas	07-0242	3/9/07	2/5/08	9/30/06	102.6	71.2	11.1	10.2
INDIANA									
Boonville Natural Gas Corp.	Gas	43342	8/29/07	8/27/08	3/31/07	0.5	0.4	11.2	10.4
Community Natural Gas Co., Inc.	Gas	43377	10/25/07	8/27/08	9/30/07	0.7	0.4	10.4	10.2
Indiana Gas Co. (Vectren North)	Gas	43298	5/18/07	2/13/08	12/31/06	41.1	26.9	10.6	10.2
Midwest Natural Gas Corp.	Gas	43229	2/26/07	11/20/07	8/31/06	2.0	1.6	NA	10.4
Ohio Valley Gas Corp.	Gas	43209	1/8/07	10/10/07	6/30/06	5.5	4.8	NA	9.95
Ohio Valley Gas, Inc.	Gas	43208	1/8/07	10/10/07	6/30/06	0.7	0.6	NA	9.95
South Eastern Indiana Natural Gas	Gas	43318-U	7/9/07	1/16/08	12/31/06	0.3	0.2	11.5	9.95
IOWA									
MidAmerican Energy Co.	Electric	RPU-08-2 ¹³ 266 PUR4th 469	5/2/08	6/16/08	NA	NA	NA	11.7 ¹⁴	11.7
KENTUCKY									
Delta Natural Gas Co., Inc.	Gas	2007-00089	4/20/07	10/19/07	12/31/06	5.64	3.92	10.5	10.5
LOUISIANA									
Cleco Power LLC	Electric	U-21496-K ¹⁵	1/31/08	NA	9/30/06	NA	NA	11.25	11.25
Cleco Rowe LLC	Electric	U-30689 ¹⁵	7/14/08	NA	6/30/09 ¹⁶	(72.3) ¹⁷	NA	11.25	NA ¹⁸
Entergy Gulf States, Inc.	Electric	U-29203 ¹⁹	NA	8/1/07	N/A	218.9	187	11.1	NA ²⁰
Entergy Louisiana, Inc.	Electric				NA	560.8	545	10.65	NA ²⁰
South Coast Gas Co., Inc.	Gas	U-29765	10/13/06	9/20/07	6/30/06	.567	.311 ²¹	NA	10.5
MASSACHUSETTS									
Fitchburg Gas & Electric Light Co.	Electric	DPU 07-71	8/17/07	2/29/08	12/31/06	3.3	2.1	10.0	10.25

Company Name	Type of Service (Electric or Gas)	Case, Docket, or Decision No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
MAINE									
Bangor Hydro-Electric Co.	Electric	20006-661	1/16/07	12/20/07	12/31/05	NA ²²	NA ²²	NA	10.2
Central Maine Power Co.	Electric	2007-215 ²³ 266 PUR4th 475	5/1/07	7/1/08	12/31/06	[20.3]	[20.3]	NA	11.0 ²⁴
MARYLAND									
Washington Gas Light Co.	Gas	9104	4/20/07	11/16/07	12/31/06	33.8	20.56	10.75	10.0
MICHIGAN									
Consumers Energy Co.	Electric	U-15245 265 PUR4th 350	3/30/07	6/10/08	2008	143.5	27.96	11.15	10.7 ²⁵
Wisconsin Public Service Corp.	Electric	U-15352	8/10/07	12/4/07	12/31/08	0.8	0.6	11.4	10.6
MISSOURI									
Empire District Electric Co.	Electric	ER-2008-0093	10/1/07	7/30/08	2/28/08	34.7	22.7	10.9	10.8
Kansas City Power & Light	Electric	ER-2007-0291	2/1/07	12/6/07	12/31/06	45.4	35.3	11.25	10.75
Missouri Gas Utility, Inc.	Gas	GR-2008-0060	8/29/07	3/20/08	3/31/07	.443	.301	NA	10.2
MONTANA									
Montana Dakota Utilities Co.	Electric	D-2007-7-79 264 PUR4th 516	7/12/07	4/23/08	NA	7.8	4.1 ²⁶	NA	10.2
Northwestern Energy Co.	Electric	D-2007-7-82	7/31/07	7/8/08	12/31/07	31.4	10.0	NA	10.25
Northwestern Energy Co.	Gas	D-2007-7-82 267 PUR4th 151	7/31/07	7/8/08	12/31/07	10.5	5.0	10.75	10.75 ²⁷
NEVADA									
Nevada Power Co.	Electric	06-11022	11/15/06	5/23/07	6/30/06	156.8	119	10.25	10.7
Sierra Pacific Power Co.	Electric	07-12001	12/3/07	6/27/08	6/30/07	110.8	87	10.6 ²⁸	10.6 ^{28,29}
Sierra Pacific Power Co.	Gas	05-10005	10/3/05	4/27/06	5/31/05	8.3	4.5	11.25	10.6
NEW MEXICO									
Public Service Co. of New Mexico	Electric	07-00077	2/21/08	4/24/08	9/30/06	77.4	35.2	10.5	10.1
NEW YORK									
Consolidated Edison Co. of New York, Inc.	Electric	07-E-0523	5/4/07	3/25/08	3/31/09	1,200	425	10.3	9.1
Consolidated Edison Co. of New York, Inc.	Gas	06-G-1332 261 PUR4th 1	11/2/06	11/2/07	10/1/07	285 ³⁰	192.5	NA	9.7 ³¹
National Fuel Gas Distribution Corp.	Gas	07-G-1047	1/29/07	12/21/07	9/30/06	52.4	1.8	NA	9.1
Orange & Rockland Utilities Inc.	Electric	07-E-0949 ³² 266 PUR4th 201	8/10/07	7/23/08	6/30/09	47.8	15.9 ³³	9.1	9.4 ³⁴
NORTH CAROLINA									
Duke Energy Carolinas, LLC	Electric	E-7, Sub 828 262 PUR4th 293	6/1/07	12/20/07	12/31/06	140.2	(233.0) ³⁵	12.5 ³⁶	11.0
OHIO									
Duke Energy Ohio, Inc.	Gas	07-589-GA-AIR	7/18/07	5/28/08	12/31/07	34	18.28	NA	NA ³⁷
Suburban Natural Gas Co.	Gas	07-689-GA-AIR	8/3/07	3/19/08	7/31/07	1.46	1.175	NA	NA ³⁷
ONTARIO									
Enbridge Gas Distribution	Gas ³⁸	EB-2006-0034	8/25/06	7/5/07	12/31/07	158.7	82	8.74	8.39
Enersource Hydro Mississauga	Electric ⁴⁰	EB-2007-0706	8/23/07	1/4/08	2008	124.3	114.6 ^{38,41}	9.0	8.57
Guelph Hydro	Electric	EB-2007-0742	2/26/08	7/31/08	2008	24.6	23.3 ³⁹	9.0	8.57
Hydro One Networks (Transmission)	Electric	EB-2007-0501	9/12/06	8/16/07	2007-2008	1,240	1,156.9 ³⁹	9.88	8.35
Hydro Ottawa	Electric	EB-2007-0713	9/19/07	3/17/08	2008	155.5	144.8 ^{38,41}	9.0	8.57



Jim Hoecker

Energy Regulation Insight

As a former chairman of the Federal Energy Regulatory Commission and a nationally-recognized energy advisor, Jim Hoecker adds strength to the energy practice at Husch Blackwell Sanders. His practice will focus on wholesale electric and gas energy markets, energy policy and climate change policy as they affect the regulated power industry. He has strong Midwestern roots and over 30 years of experience in the energy regulatory business. This public sector energy leader joins as one of Husch Blackwell Sanders' newest attorneys. Welcome.

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Company Name	Type of Service (Electric or Gas)	Case, Docket, or Decision No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
Toronto Hydro-Electric System Limited	Electric	EB-2007-0680	8/3/07	5/15/08	2008-2010	490.5	473	9.0	8.57
OKLAHOMA Public Service Co. of Oklahoma	Electric	200600285	11/21/06	10/9/07	6/30/06	49.5	9.8	10.7	10.0
OREGON Avista Utilities	Gas	UG-181	10/12/07	3/31/08	12/31/06	2.975	.866	10.25	10.0
SOUTH DAKOTA NorthWestern Energy	Gas	NG07-013	6/1/07	12/28/07	12/31/06	3.7	3	10.25	-42
SOUTH CAROLINA Piedmont Natural Gas Co.	Gas	2005-125-G ⁴³	8/31/07	10/12/07	3/31/07	[2.5]	[2.5]	11.2	11.2
South Carolina Electric & Gas	Electric	2007-229-E	6/15/07	12/14/07	3/31/07	118	76.9	10.7	11.0
TEXAS AEP Texas Central Co.	Electric	33309	10/4/06	12/13/07	6/30/06	62.7	(40.2)	10.125	9.96
AEP Texas North Co.	Electric	33310	10/4/06	5/29/07	6/30/06	18.8	7.2	11.25	9.96
Southwestern Public Service Co.	Electric	32766	5/31/06	7/27/07	9/30/05	47.9	23	11.5	-44
UTAH PacifiCorp	Electric	07-035-93	12/17/07	8/21/08	12/31/08	74.456	36.164	10.25	10.25

Company Name	Type of Service (Electric or Gas)	Case, Docket, or Decision No.	Application Date	Order Date	Test-year End Date	Increase [Decrease] Requested (\$Million)	Increase [Decrease] Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate %	Newly Authorized Rate %
Qwestar Gas Co.	Gas	07-057-13	12/19/07	6/27/08	12/31/08	22.158	11.967	11.2	10.0
Rocky Mountain Power Co.	Electric	07-035-93 267 PUR4th 1	12/12/07	8/11/08	12/31/08	161.2	36.164	NA	10.25
VERMONT Central Vermont Public Service Corp.	Electric	7321 264 PUR4th 1	5/15/07	1/31/08	12/31/06	12.414	6.402 ⁴⁵	10.7	10.7 ⁴⁶
VIRGINIA Washington Gas Light Co.	Gas	PUE-2006-00059 261 PUR4th 325	4/27/06	9/19/07	12/31/05	23.0	3.9 ⁴⁷	10.5	10.5 ⁴⁸
Roanoke Gas Co.	Gas	PUE-2007-00086	9/17/07	5/22/08	6/30/07	.695	.416	10.1	10.0
WASHINGTON Avista Utilities	Electric	UE-070804	4/26/07	12/19/07	12/31/06	51.1	30.2	10.4	10.2
Avista Utilities	Gas	UG-070805	4/26/07	12/19/07	12/31/06	4.5	3.3	10.4	10.2
WISCONSIN Madison Gas & Electric Co.	Electric	3270-UR-115	5/7/07	12/14/07	12/31/08	19.6 ⁴⁹	16.2	11.0	10.8
Madison Gas & Electric Co.	Gas	3270-UR-115	5/7/07	12/14/07	12/31/08	9.1	7.8	11.0	10.8
Northern States Power-Wisconsin	Electric	4220-UR-115 264 PUR4th 236	6/1/07	1/8/08	12/31/08	67.4	39.4	11.0	10.75
Northern States Power-Wisconsin	Gas	4220-UR-115 264 PUR4th 236	6/1/07	1/8/08	12/31/08	5.3	5.3	11.0	10.75
Wisconsin Electric Power Co.	Electric	05-UR-103 262 PUR4th 433	5/21/07	1/17/08	12/31/08	170.3 ⁵⁰	389.1 ⁵¹	11.2	10.75
Wisconsin Electric Power Co.	Gas	05-UR-103 262 PUR4th 433	5/7/07	1/17/08	12/31/08	11.8	4.0	11.2	10.75
Wisconsin Gas Co.	Gas	05-UR-103	5/7/07	1/17/08	12/31/08	36.1	20.1	11.2	10.75
WYOMING Cheyenne Light, Fuel & Power	Electric	20003-90-ER-07	3/1/07	5/2/08	9/30/07	8.4	6.7	10.75	10.9
Cheyenne Light, Fuel & Power	Gas	30005-112-GR-07	3/1/07	5/2/08	9/30/07	4.6	4.4	10.75	10.9
PacifiCorp	Electric	20000-277-ER-07	6/29/07	4/28/08	8/31/08	36.1	23.0	10.75	10.25
Pinedale Natural Gas, Inc.	Gas	30016-41-GR-06	2/6/06	10/2/08	12/31/06	0.09	NA	10.9	10.75

Endnotes

- Utility operates under a rate stabilization and equalization (RSE) plan – an alternative rate-making mechanism that provides for periodic automatic adjustments to maintain ROE within a specified range. ROE figure shown is midpoint of approved range.
- Order renews existing RSE approved by Order issued 6/10/2002 for period of seven years ending on Dec. 31, 2014.
- Includes phase-down of existing cap on ratio of common equity to average capitalization to 57% by Dec. 31, 2008 and to 55% by Dec. 31, 2009.
- Produces overall rate of return on “fair value” rate base of 7.03%.
- Settlement stated ROE; ROE figure reflects downward adjustment for reduced risk associated with billing determinant adjustment tariff.
- Order adopting ratemaking cost of capital for major investor-owned energy utilities.
- By subsequent order commission adopts a multi-

year cost-of-capital mechanism (CCM) for major utilities. Under CCM, utilities will file applications every third year beginning in April 2010. Changes in interest rates outside of a 100-basis point dead band would trigger off-year adjustments. See *Re Southern California Edison Co.*, 265 PUR4th 161 (Cal.P.U.C.2008).

- Order determining utility earned \$15.5 million in excess of allowed ROE.
- Allowed ROE approved March 14, 2007 rate-case decision.
- Department finds 10.1% ROE reasonable for current earnings review.
- No ROE was specified in the Settlement Agreement. However, in a subsequent filing WGL reported that an ROE of 10% was used to calculate carrying costs.
- \$98.6 million requested in application, modified to \$63 million, to reflect the Hawaii PUC's decision to separate HECO's DSM program costs from the rate case to a separate docket.
- Order granting application for a determination of

advanced ratemaking principles for a proposed wind-generation project.

- Result from two most recent dockets involving wind-power projects.
- Proceeding to review level of earnings under formula rate plan.
- Test year utilized is actual year ending September 30, 2007 with *pro formas* to June 30, 2009 and Rodemacher Unit No. 3 full year operations.
- The components are as follows: Base Rate Increase \$250.1 million; Fuel Cost Savings (\$224.4) million; Refund of RPS-3 Carrying Charges (\$98) million; Net Decrease (\$72.3) millions.
- Company requested 12.25% ROE.
- Order granting requests by two electric utilities for permanent rate recovery of costs associated with damages caused by Hurricanes Rita and Katrina.
- Utilities directed to file full ROE analysis reflecting reduced risk associated with “up-front” recovery of future storm costs.
- Increase to monthly customer charge for increased

operating expense and equipment replacement. Commission also approves "Capital Surcharge" to generate \$.546 million over five-year period to fund capital additions.

22. Figures shown are total revenue requirement, not revenue sufficiency or deficiency. Approved settlement agreement based on \$54.4 million total revenue requirement. Company initially requested rates to recover \$56.6 million in revenue.
23. Order approving stipulation that decreases electric distribution rates and establishes a new five-year alternative rate plan.
24. Rate plan contains a high-end earnings-sharing provision mandating reliability investments if earnings exceed 11% ROE during term of rate plan.
25. Reflects reduced risk to investors stemming from improvements in capital structure and divestiture of nuclear assets.
26. Settlement agreement.
27. Settlement silent on ROE. Utility continues to use ROE authorized in prior rate case.
28. Demand-side management programs in rate base earn a 5% enhancement on ROE, or 15.6%.
29. The Tracy combined-cycle generating unit earns a 1.5% incentive ROE, or 12.1%.
30. Revenues required under three-year rate plan.
31. Rate order includes earnings-sharing plan allocating 50% of actual earnings above 10.7% ROE to shareholders.
32. Order establishing three-year rate plan.
33. Figure shown is levelized annual increase for each of three rate years ending June 30, 2009, 2010 and 2011.
34. Equity earnings sharing mechanism with 50% sharing of earnings between 10.2% and 11.2%, 7.5% above 11.2%. Figure shown is base figure for revenue requirement.
35. Commission orders further reduction of \$53.924 million for issues not settled under stipulation.

ROE SURVEY METHODOLOGY

Fortnightly's 2008 ROE survey covers cost of equity capital determinations by state public utility commissions during the period Sept. 1, 2007 through Aug. 31, 2008. (A few more recent cases outside the period are provided where available.) *Fortnightly's* methodology remains similar to its previous ROE surveys; requests for information on the results of recent rate proceedings were sent to both regulators and utility financial officials. In addition, direct examination of commission rate orders, when available, provided additional information.

The traditional cost-of-service rate case remains the primary source of information on how utility regulators view the issue of shareholder earnings requirements. Nevertheless, performance-based rate plans and cases called to conduct periodic earnings reviews also contain findings about the appropriate ROE for utilities, and are reported in this survey. Explanatory notes accompany most entries, and citations are provided for orders published in *Public Utilities Reports, Fourth Series (PUR4th)*.

36. Last rate order issued 2002.
37. Settlement agreement. ROE not specified.
38. ROE for natural gas distribution utilities set in accordance with *OEB Draft Guidelines on a Formula-Based Return on Common Equity for Regulated Utilities (Ontario Energy Board, March 1997)*.
39. For electricity rate applications (transmission and distribution) the \$ shown as requested and approved are the total revenue requirement, not as revenue sufficiency or deficiency.
40. ROE for electricity transmitters and distributors set, beginning on 2007 in accordance with the *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors*.
41. Settlement agreement.
42. Settlement agreement. ROE not specified.
43. Application to adjust rates under formula rate plan.
44. Settlement agreement. ROE not specified.
45. Board approves memorandum of understanding (MOU) as a bottom-line settlement in which overall rate level is found just and reasonable.
46. Figure shown stated in MOU pending adoption of alternative regulation plan or order in future rate proceeding.
47. Approved stipulation authorizes stated revenue increase, as well as a four-year, performance-based rate plan.
48. Plan required company to share with ratepayers earnings in excess of 10.5%.
49. Subsequently revised to \$34 million.
50. Net of Point Beach nuclear power plant credits. Effective increase for 2009 of \$183.5 million net of Point Beach credits.
51. Offset by a credit of \$315.9 million for the sale of the Point Beach Nuclear Power Plant. Credit reduced to \$240.7 million in 2009.

Fortnightly.com Webcast

REGULATORS ON SMART METERING AND UTILITY RATEMAKING

Fortnightly.com will unveil a webcast program featuring teleconferences with several state utility commissioners. We asked regulators for their views on efficiency and conservation, smart grid investments and the evolving utility compact. Here's a sneak preview of comments from our July 15 conference with Frederick Butler, New Jersey Department of Public Utilities; Jackahyne Pfannenstiel, California Energy Commission; and Rick Morgan, Washington, D.C., Public Service Commission:

Morgan, DC PSC: One of the messages we've heard over and over is there's no point in having smart meters if you have dumb rates. You need rates that take advantage of those meters and provide the opportunity to save energy and save money.

Pfannenstiel, CEC: Do utilities' revenues get eroded from price signals that we're passing on to customers? How that works is the only part of the regulatory compact that may have to be rethought.

Butler, NJ DPU: We have to come up with a system that allows utilities to encourage conservation without going their own way. I don't subscribe blindly to the concept of decoupling, but it's the kind of thing we have to be flexible with, in terms of the regulatory compact.

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Commission Watch

2009 ROE Survey

Austerity Savings

Volatile economic conditions push regulators in new directions.

BY PHILLIP S. CROSS

A review of the rate cases decided over the past year indicates that the economy remains at the forefront in the news, and on the minds of regulators in rate-case proceedings. The issue has taken a new twist, however, as regulators are now placed in the unenviable position of determining an allowance for return on equity (ROE) that's fair to consumers and investors in a volatile economy. When *Fortnightly* presented this feature last year, we reported that regulators were seeking to determine the effect the dip in the stock market, falling interest rates and tightening credit might have on financial modeling, as well as subjective views of the return necessary to attract investors. This time, the cases that stand out are those in which regulators are exploring the limits of their discretion under the regulatory compact to balance the interests of consumers and shareholders in the face of a severe economic downturn.

The task of setting the return or profit component of regulated rates for utility service is one that begins with a review of mathematically derived estimates of the return expected by investors in the future. Regulators also are called on to use their informed judgement to produce a result that's fair to consumers and investors alike. The final answer often is expressed as a range of "reasonable" results that would at either end provide a fair return to investors and reasonable rates for consumers. This gives regulators some wiggle room when determining a final ROE figure or when seeking other ways to hold down rates for consumers—or to keep rates high enough to make sure a utility has access to capital.

A recent case decided in Michigan shows how the financial crisis might rebound to the benefit of shareholders in a rate-case setting. In that case, the state public service commission (PSC) ruled that Detroit Edison's ROE should remain at 11 percent, even though its staff recommended a rate of 10.5 percent and other parties presented evidence

supporting lower figures. The utility had asked for an allowance of 11.25 percent, a rate only slightly above the approved rate set in 2006. The PSC concluded that maintaining the status quo on the company's ROE in light of Michigan's economic circumstances and the U.S. credit crisis was the most prudent course



of action. The commission said the worldwide crisis and ensuing breakdown in confidence among financial institutions led to rising long-term borrowing rates. It also noted that the credit-system freeze causes concern for the utility's continued ability to provide financing for infrastructure investment needs, and then to continue to provide safe, reliable and abundant power at reasonable rates. The PSC concluded that "a cautious approach in changing the company's ROE is necessary to ensure investor confidence and company access to capital markets" [*Re The Detroit Edison Co., Case No. U-15244, 270 PUR4th 134 (Mich.P.S.C.2008)*].

Discretionary Cuts

Regulators in Connecticut looked at the crisis another way. While setting rates for United Illuminating (UI), the Connecticut Department of Public Utility Control (DPUC) lowered the company's ROE from a level of 9.7 percent set in 1996 to 8.75 percent in a rate case heard this year. It rejected a claim by the electric utility that financial models relied on in the past should be adjusted to account for a change in investor behavior as a result of the crisis, including a shift away from looking at dividend payments as a measure of long-term growth and instead focusing more on earnings per share as a guide to investment decisions. The company claimed that dividend growth has remained stagnant due to heightened financial concerns in the utility industry. Expressing a keener interest in the macroeconomic issues at play, the DPUC concluded that although the overall outlook for the economy as a whole is weak, investors likely will continue looking to the utility sector as a safe haven amidst a volatile market

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environment. The DPUC said that even though the company was embarking on a high volume of capital spending and infrastructure improvements, that would be offset by UI's strong financial position, limited risk profile, visible forward-earnings stream, high dividend yield, strong balance sheet and strong cash position. Despite higher spreads and yields, utilities still outperform most sectors of the bond market. As such, the cost of equity for the electric industry is among the lowest of all industries in the United States. All these indicators suggested a substantial decline in the overall equity cost rate, in the view of the DPUC [*Re The United Illuminating Co., Docket No. 08-07-04, Feb. 4, 2009 (Conn.D.P.U.C.)*].

Focusing directly on the plight of consumers during the current economic crisis, the DPUC in a second case reduced rates for a natural gas local distribution company (LDC) by \$16.2 million, reflecting an allowed ROE of 9.31 percent. The department rejected claims by the utility that a rate increase was required due to current economic conditions that had resulted in nearly 15,000 residential service terminations due to non-payment of bills. Rather than hike rates to cover past-due bills, the current economic conditions required the LDC to share in the economic difficulties of Connecticut citizens by aggressively managing its operational expenses and capital investments, the department said. Driving home this point, the DPUC disallowed for rate-making purposes, costs incurred for non-qualified pension plans, finding that ratepayers shouldn't have to fund excessive pension benefits in difficult economic times [*Re Connecticut Natural Gas Corp., 274 PUR4th 345 (Conn.D.P.U.C. 2009)*].

In perhaps the most dramatic example of ratemaking meets an economy in crisis, the New York Public Service Commission (PSC) has in recent cases

addressed consumer issues by imposing what it calls an "austerity savings" adjustment for energy utilities operating in the state. In those cases, the PSC actually increased the ROE in accordance with the results of financial models, but at the same time took away revenues by adjusting cost-of-service estimates to reflect the savings expected under mandated austerity savings programs. The PSC was careful to explain, however, that if the cost savings weren't found, the utility could petition for a deferral of the costs and possible recovery in a future rate period.

When consumers are experiencing a harsh economic climate, regulators expect frugality from utilities.

For example, the PSC recently has approved a rate increase of \$721 million for Consolidated Edison of New York. In that case, the PSC established an ROE of 10 percent for the utility, an increase from its earlier authorized ROE of 9.1 percent. The PSC reviewed several measures designed to reduce the level of the increase in the context of the current economic downturn. It deter-

mined that Con Edison should impose additional cost-cutting measures and directed the company to identify and implement an "austerity budget" that would reduce its revenue requirement by \$60 million for the coming year.

The issue of the proper ROE remained separate from the austerity savings ruling, however. Through the trial briefing stage, the company supported an 11-percent equity return allowance but reflected only 10 percent in its May 2008 tariff filing. The PSC noted that it's unusual for a utility to support one equity return in testimony and to reflect a lower one in the revenue request set forth in its tariff filing, but accepted the filing and went on to examine the results of financial models presented in the case. The PSC did note that the revenue requirement difference between 10 percent and 11 percent was approximately \$115 million a year. The company described its 10-percent request as part of its proposal to "ameliorate bill impacts on customers." The PSC went on to find that assigning a two-thirds weight to results under its own discounted cash flow analysis, and one-third weight to an average of the capital asset pricing model to the results presented by the parties to the case, showed that independent of the company's offer to settle for a 10-percent return based on its original request,

ROE SURVEY METHODOLOGY

Fortnightly's 2009 ROE survey covers cost of equity capital determinations by state public utility commissions during the period Sept. 1, 2008 through Aug. 31, 2009. (A few more recent cases outside the period are provided where available.) *Fortnightly's* methodology remains similar to its previous ROE surveys; requests for information on the results of recent rate proceedings were sent to both regulators and utility financial officials. In addition, direct examination of commission rate orders, when available, provided more information.

The traditional cost-of-service rate case remains the primary source of information on how utility regulators view the issue of shareholder earnings requirements. Nevertheless, performance-based rate plans and cases called to conduct periodic earnings reviews also contain findings about the appropriate ROE for utilities, and are reported in this survey. Explanatory notes accompany most entries, and citations are provided for orders published in *Public Utilities Reports, Fourth Series (PUR4th)*.—P.S.C.

the same increase in the company's ROE proved to be the one that the evidence had shown to be adequate to compensate investors and attract capital in the near future.

Nevertheless, turning back to the issue of the macroeconomic concerns in the marketplace, the PSC stated that expenditures that are reasonable during average or good economic times aren't necessarily reasonable when economic conditions are extremely poor. When consumers are experiencing an extraordinarily harsh economic climate, a certain measure of frugality is properly expected from utilities

and a reprioritizing of expenditures may be needed, the PSC said, citing such measures as freezing executive pay, restricting hiring, cutting travel costs and other so-called "discretionary" expenses. With this said, it ordered a downward adjustment to the company's revenue requirement amounting to \$60 million, half of which will be subject to further review and potential deferral based on a review of the company's ability and best efforts to implement the required measures effectively. It pointed out that this amounts to approximately 3.6 percent of non-fuel operation and maintenance

costs and emphasized that the company's management will be responsible for determining how best to achieve the \$60 million revenue requirement reduction while maintaining reliability, service quality, and safety [*Re Consolidated Edison Co. of New York, Inc., Cases 08-E-0539, 08-M-0618, Apr. 24, 2009 (N.Y.P.S.C.)*; *See also Central Hudson Gas & Electric Corp., 274 PUR4th 257 (N.Y.P.S.C. 2009) where the PSC also discussed macroeconomic conditions that may be used as a basis for requiring the so-called austerity adjustments to a company's revenue requirements*]. ■

Company	Utility Type	Case, Docket or Decision	Application Date	Order Date	Test-year End Date	Increase (Decrease) Requested (\$Million)	Increase (Decrease) Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate (%)	Newly Authorized Rate (%)
Arkansas Oklahoma Gas & Electric	Electric	08-103-U	8/29/08	5/20/09	12/31/07	26.4	13.6	10	10.25
Arizona Southwest Gas	Gas	G-01551A-07-0504, 270 PUR4th 465	8/31/07	12/24/08	4/30/07	50.2	33.5	9.5	10
California Southwest Gas - Northern Jurisdiction	Gas	07-12-022	12/21/07	11/21/08	12/31/09	-0.1	-1.04	10.9	10.5
Southwest Gas - South Lake Tahoe Jurisdiction	Gas	07-12-022	12/21/07	11/21/08	12/31/09	2.1	1.82	NA	10.5
Southwest Gas - Southern Jurisdiction	Gas	07-12-022	12/21/07	11/21/08	12/31/09	7.1	2.44	10.9	10.5
Colorado Black Hills Energy	Gas	08S-2906	6/30/08	3/10/09	12/31/07	2.7	1.38	12	10.25
Public Service of Colorado	Electric	08S-520E, C09-0595, 275 PUR4th 149	11/25/08	6/9/09	12/31/09	174.4	12.0	10.5	10.5 ¹
Connecticut Connecticut Natural Gas	Gas	08-12-06, 274 PUR4th 345	1/16/08	6/30/09	6/30/08	16.4	-16.2	10.1	9.41 ²
Southern Connecticut Gas	Gas	08-12-07	1/20/08	7/17/09	6/30/10	50.1	-12.46	10	9.26
United Illuminating	Electric	08-07-04	8/8/08	6/3/09	12/31/07	52.2	25.27 ³	9.75	8.75
Delaware Chesapeake Utilities	Gas	07-186, 268 PUR4th 370	7/6/07	9/2/08	3/31/07	1.9	0.329	10.86	10.25
Florida Peoples Gas System	Gas	080318-GU, 274 PUR4th 177	8/1/08	6/9/09	12/1/09	26.5	19.2	11.25	10.75
Tampa Electric	Electric	080317-EI	8/1/08	4/30/09	12/1/09	228.2	147.3	11.75	11.25
Idaho Atlanta Power	Electric	ATL-E-08-02, 271 PUR4th 134	5/1/08	12/19/08	12/31/06	0.109	0.106	NA	12 ⁴
Avista	Electric	AVU-E-08-01	4/3/08	9/30/08	12/31/07	32.3	23.20 ⁵	NA	10.2
Avista	Gas	AVU-G-08-01	4/3/08	9/30/08	12/31/07	4.7	3.90 ⁵	NA	10.2
Rocky Mountain Power	Electric	PAC-E-08-07	9/19/08	4/16/09	12/31/07	5.9	4.38	10.25	10.25 ⁵
Illinois Commonwealth Edison	Electric	07-0566, 268 PUR4th 1	10/17/07	9/10/08	12/31/06	362.3	273	10.045	10.3
Northern Illinois Gas	Gas	08-0363, 272 PUR4th 161	4/29/08	3/25/09	12/31/09	140.4	69	8.85	10.11

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								Previously Authorized Rate (%)	Newly Authorized Rate (%)
Indiana									
Indiana Michigan Power	Electric	43306, 273 PUR4th 310	6/19/07	3/4/09	9/30/07	125.5	41.6	12	10.5
Indiana Natural Gas	Gas	43434	1/30/08	10/8/08	8/31/07	0.7	0.5	10.4	10.2
Indiana Utilities	Gas	43520	6/17/08	1/21/09	12/31/07	0.4	0.4	10.4	10.3
Iowa									
Black Hills Energy	Gas	RPU-08-3, 275 PUR4th 44	6/2/08	6/3/09	12/31/07	13.56	10.39*	NA*	10.1
Interstate Power & Light	Electric	RPU-08-1	3/31/08	2/13/09	NA	NA	NA	NA	10.1*
MidAmerican Energy	Electric	RPU-08-4	7/23/08	8/27/08	NA	NA	NA	NA	11.7*
Kansas									
Westar Energy	Electric	08-WSEE-1041-RTS	5/28/08	1/21/09	12/31/07	90	65	10	10.4*
Kentucky									
Kentucky Utilities	Electric	2007-00565	7/1/08	2/5/09	4/30/08	22.2	-8.9*	11	10.63
Louisiana									
Cleco Power LLC	Electric	U-21496-K	6/1/09	NA	9/30/08	NA*	NA	11.25	11.25
Cleco Power LLC	Electric	U-30689	7/14/08	NA	6/30/09*	250.1	173.3	11.25	NA**
Massachusetts									
New England Gas	Gas	08-35, 271 PUR4th 1	7/17/08	2/2/09	12/31/07	5.6	3.68	NA	10.05
Michigan									
Detroit Edison	Electric	U-15244	4/13/07	12/23/08	12/31/06	123	83.629	11	11
Michigan Gas Utilities	Gas	U-15549	5/16/08	1/13/09	12/31/09	13.9	6	11.4	10.45
Minnesota									
Minnesota Energy Resources	Gas	GR-08-835	7/31/08	6/29/09	12/31/08	22	15.4	11.71	10.21
Minnesota Power	Electric	E-015/GR-08-415	5/2/08	5/4/09	6/30/09	39.8	20.4	11.6**	10.74
Missouri									
AmerenUE	Electric	ER-2008-0318, 271 PUR4th 475	4/4/08	1/27/09	3/31/08	251	162	10.2	10.76
Kansas City Power & Light	Electric	ER-2009-0089	9/5/08	6/10/09	12/31/07	101.5	95	10.75	NA*
Kansas City Power & Light (Greater Missouri Operations*)	Electric	ER-2009-0090	9/5/08	6/10/09	12/31/07	83.1	63	10.25	NA*
Mississippi									
CenterPoint Energy	Gas	Rider RRA**	1/2/08	11/17/08	9/30/07	2.5	0.9	9.86	9.67
Montana									
Montana-Dakota Utility	Electric	D2007.7.79, 264 PUR4th 516	7/12/07	4/23/08	12/31/06	7.77	4.1	12.3	10.25
NorthWestern Energy	Electric	D2007.7.82	7/31/07	7/7/08	12/31/06	31.37	10	10.75	NA*
NorthWestern Energy	Gas	D2007.7.82	7/3/07	7/7/08	12/31/06	10.5	5	10.75	NA*
NorthWestern	Electric	D2008.6.69, 269 PUR4th 277**	6/27/08	11/13/08	NA				10**
Nevada									
Nevada Power dba NV Energy	Electric	08-12002	12/1/08	6/24/09	6/30/08	324	224	10.7	10.5
New Jersey									
New Jersey Natural Gas	Gas	GR07110889	11/20/07	10/3/08	4/30/08	58.36	32.5	11.5	10.3
New Mexico									
Southwestern Public Service	Electric	08-00354-UT	12/18/08	7/14/09	6/30/08	24.6	14.2	10.5	NA*
Zia Natural Gas	Gas	08-00036-UT	1/31/08	11/25/08	8/31/08	3.2	2.5	NA	10.27**
New York									
Central Hudson Gas & Electric	Electric	08-E-0887	7/31/08	6/22/09	6/30/10	66.1	38**	9.6	10
Central Hudson Gas & Electric	Gas	08-G-0888, 274 PUR4th 257	7/31/08	6/22/09	6/30/10	20.2	13.6**	9.6	10
Consolidated Edison of New York	Electric**	08-E-0539	5/9/09	3/24/09	3/31/10	935.1	721.4	9.1	10
Conning Natural Gas	Gas	08-G-1137	9/24/08	8/20/09	6/30/10	1.7 ²⁰	0.973 ²¹	10 ²²	10.7 ²³
North Carolina									
Piedmont Natural Gas	Gas	G-9, Sub 550, 269 PUR4th 320	2/29/08	10/24/08	12/31/08	40.51	15.68	NA	10.6 ²⁴
North Dakota									
Northern States Power	Electric	PU-07-776, 271 PUR4th 333	12/7/07	1/14/09	12/31/08	17.9	10.9	12	10.75

Company	Utility Type	Case, Docket or Decision	Application Date	Order Date	Test-year End Date	Increase (Decrease) Requested (\$Million)	Increase (Decrease) Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate (%)	Newly Authorized Rate (%)
Ohio									
Cleveland Electric Illuminating	Electric	07-552-EL-UNC ²⁵	5/8/07	1/21/09	2/29/08	108.6	29.2	NA	10.5 ²⁶
Columbia Gas of Ohio	Gas	08-72-GA-AIR	3/3/08	12/3/08	9/20/08	87.81	47.14	NA	10.39
Duke Energy Ohio	Electric	08-709-EL-AIR	7/25/08	7/8/09	12/31/08	85.6	55.3	10.29	10.63
East Ohio Gas dba Dominion East Ohio	Gas	07-829-GA-AIR	10/30/07	10/15/08	12/31/07	76.02	37.48	12.15	9.92
Ohio Edison	Electric	07-552-EL-UNC ²⁵	5/8/07	1/21/09	2/29/08	160.7	68.9	NA	10.5
Toledo Edison	Electric	07-552-EL-UNC ²⁵	5/8/2007	1/21/09	2/29/08	70.5	38.5	NA	10.5
Vectren Energy Delivery of Ohio	Gas	07-1081-GA-AIR	11/20/07	1/7/09	5/31/08	27.33	14.78	10.60	10.65
Oklahoma									
CenterPoint Energy	Gas	PUD-20900055	3/13/09	7/9/09	12/31/07	1.9	1.5	10.25	10.5
Oregon									
Portland General Electric	Electric	UE 197	2/27/08	1/1/09	12/31/09	146	120	10.1	10.1
Pennsylvania									
Columbia Gas of Pennsylvania	Gas	2008-2011621	1/28/08	10/28/08	9/30/08	58.9	41.5	NA*	NA*
Equitable Gas	Gas	R-2008-2024325	6/30/08	2/26/09	12/31/08	51.949	38.35 ²⁷	NA*	NA*
Rhode Island									
Narragansett Electric	Gas	3943, 272 PUR4th 96	4/1/08	1/29/09	9/30/07	20.04	13.66	NA	10.5
South Dakota									
Otter Tail Power	Electric	EL08-030	10/31/08	6/30/09	12/31/07	3.9	3	11.75 ²⁸	NA*
Texas									
Entergy Texas	Electric	34800	9/26/07	3/16/09	3/31/07	605	46.7	10.95	10
Oncor Electric Delivery	Electric	35717	6/27/08	8/31/09	12/31/07	253.5	115.1	11.25	10.25
Southwestern Public Service	Electric	35763	6/12/08	6/2/09	12/31/07	84.2	57.4	11.50	NA ²⁸
Texas-New Mexico Power	Electric	36025	8/20/08	8/21/09	3/31/08	8.7	6.8	11.25	10.25*
Utah									
Rocky Mountain Power, a division of PacifiCorp	Electric	08-035-38	4/7/08	4/21/09	12/31/07	160.6	45.0	10.25	10.61 ²⁴
Vermont									
Central Vermont Public Service	Electric	7485	10/31/08	2/13/09	12/31/07	0.94	NA	10.21	9.77 ²⁹
Virginia									
Appalachian Power ³¹	Electric	PUE-2008-00045	5/30/08	10/15/08	12/31/07	66.5	60.6	10.2	10.2 ²⁴
Appalachian Power	Electric	PUE-2008-00046	5/30/08	11/17/08	12/31/07	207.9	167.9	10	10.2 ²⁴
Atmos Energy	Gas	PUE-2008-00007	3/6/08	9/30/08	9/30/07	0.9	0.9	10	10 ²⁴
Roanoke Gas	Gas	PUE-2008-00088	9/16/08	6/10/09	6/30/08	1.2	1.2	10.1	10.1 ²⁴
Washington									
Avista	Electric	UE-080416	3/4/08	12/29/08	12/31/07	36.6	32.5	10.2	10.2
Avista	Gas	UG-080417	3/4/08	12/29/08	12/31/07	6.6	4.8	10.2	10.2
Northwest Natural Gas	Gas	UG-080546	3/28/08	12/26/08	9/30/07	4.3	2.72	NA	10.1
PacifiCorp	Electric	UE-080220	2/6/08	10/8/08	6/30/07	34.9	20.4	10.2	10.2
Puget Sound Energy	Electric	UE-072300	12/3/07	10/8/08	9/30/07	174.8	130.2	10.4	10.15
Puget Sound Energy	Gas	UG-072301	12/3/07	10/8/08	9/30/07	56.8	49.2	10.4	10.15
Wisconsin									
Northern States Power	Electric	4220-UR-115, 264 PUR4th 236	6/1/07	1/8/08	12/31/08	67.4	39.4	11	10.75
Northern States Power	Gas	4220-UR-115, 264 PUR4th 236	6/1/07	1/8/08	12/31/08	5.3	5.3	11	10.75
Wisconsin Power & Light	Electric	6680-UR-116	2/22/08	12/30/08	12/31/09	93.3	0	10.8	10.8 ³²
Wisconsin Power & Light	Gas	6680-UR-116	2/22/08	12/30/08	12/31/09	0.8	-3.9	10.8	10.8 ³²
Wisconsin Public Service	Electric	6690-UR-119, 270 PUR4th 421	4/1/08	12/30/08	12/31/09	84.8	0	10.9	10.9 ³²
Wisconsin Public Service	Gas	6690-UR-119, 270 PUR4th 421	4/1/08	12/30/08	12/31/09	15.7	-3	10.9	10.9 ³²
Wyoming									
Rocky Mountain Power	Electric	20000-333-ER-08, 275 PUR4th 127	NA	5/20/09	NA	NA	18	10.25	10.25 ³³
Wyoming Gas	Gas	30009-48-GR-08	10/17/08	7/1/09	5/31/08	1.61	1.31		10.87
Questar Gas	Gas	30010-94-GR-08	NA	7/1/09	12/31/08	.483	.378	NA	10.5

NOTES

- * Settlement agreement. No ROE figure stated.
1. Parties to approved settlement agree to use currently authorized ROE of 10.5% to calculate new rates and for future regulatory filings through 12/31/09.
 2. Authorized rate shown is reduced by 10-basis points in setting final revenue requirement for management imprudence concerning billing problems.
 3. Revenue amount is award for final two years of company's four-year rate plan.
 4. Commission states that 12% rate is equal to return allowed for other small utilities in the state.
 5. No ROE stated in settlement agreement on commission order reflecting significant difference in party positions. Parties agree to use existing rate of 10.25% for other purposes such as avoided cost filings.
 6. Result from an "advanced ratemaking principles" case involving a coal-fired generating facility.
 7. Result from an "advanced ratemaking principles" case (settlement) involving wind-power projects.
 8. Figure reflects specific finding by commission regarding appropriate ROE for future environmental cost recovery filings.
 9. Proceeding to review level of earnings under established formula rate plan.
 10. Test year utilized is actual year ending Sept. 30, 2007 with *pro formas* to June 30, 2009 and Rodemacher Unit No. 3 full year operations.
 11. ROE range of 10.7% to 11.3%.
 12. Figure shown contained in rate case order decided in 1994.
 13. Formerly Aquila Electric Operations.
 14. Rate Regulation Adjustment Rider. Formula rate mechanism features an annual recalculation of the allowed ROE and a graduated sharing of earnings above the authorized figure.
 15. Order authorizing an electric utility to include in rate base, at a value of \$407 million, its interest in a coal-fired generating plant.
 16. Revenue requirement for the life of the plant is based on the ROE figure shown.
 17. Order states that the ROE figure adopted only for the current rate case has no precedential value. Commission cites as a basis for this comment the utility's small size relative to other gas utilities in the state, as well as its status as a privately held entity.
 18. Figures reflected downward "austerity adjustment" to revenue requirement of \$2.4 million for electric service and \$.6 million for natural gas. Adjustment reflects recognition of economic downturn. Adjustment will have no effect on ROE if utility defers or reduces expenses by an equal amount.
 19. Delivery Service for full-service and retail-access customers.
 20. Annual increase for year ending June 30, 2010. Joint proposal submitted supplants rate application and calls for a three-year rate plan with earnings sharing adjustment mechanism.
 21. Rate period 9/1/09 through 8/31/10.
 22. Settlement approved 5/22/06.
 23. If utility elects to file for new rates prior to 10/1/2010, ROE resets to 10.5%.
 24. Figure included in approved settlement agreement.
 25. Rate filing for First Energy operating companies' electric distribution services.
 26. Midpoint of range of 10% to 11% adopted by commission.
 27. Total award includes a separate adjustment for low-income customer assistance program, which is reconciled annually.
 28. Figure shown approved in 1987 rate order.
 29. Settlement agreement. 10.25% ROE set for calculation of allowance for funds used during construction during rate-effective period.
 30. Calculated using formula set forth in alternative regulation plan.
 31. Proceeding concerning environmental and system reliability costs only.
 32. Company reports that figure shown is implied as part of revenue settlement process. ROE not stated in commission order.
 33. Approved revenue stipulation does not state authorized ROE. Commission found it appropriate to continue to use 10.25% ROE adopted in the company's last rate case for purposes of evaluating earnings on a prospective basis.

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Commission Watch

Baked-In or Decoupled?

Rate case risk in a climate of declining sales.

BY PHILLIP S. CROSS

A review of electric and natural gas rate cases decided over the past 12 months shows state utility regulators struggling to balance the interests of ratepayers and investors in an economy that continues to put pressure on both. A major factor in many cases was a decline in actual retail energy sales—whether attributable to the depressed economy or efforts to promote conservation and energy efficiency.

Decoupling plans offer a remedy for such shortfalls in sales. Decoupling plans serve to sever the link between energy sales and the rate case revenue requirement, so that utility earnings won't suffer, even as consumers conserve energy. Decoupling plans allow regulators to promote energy efficiency and conservation without imposing undue financial risk on utilities and their investors. Yet they also introduce a new complication in retail utility rate cases. Decoupling tends to shift rate case risk from investors to customers—a result that some consumer advocates say should require a downward adjustment to the authorized target rate for ROE.

In fact, several rate cases decided during the past year and included in the following list can serve as examples of how state regulators are dealing with utility revenue risk in an unfavorable economic climate. In Maryland and the District of Columbia, in electric rate cases for PEPSCO and Delmarva Power & Light, regulators adopted downward adjustments of 50 basis points to account for the fact that decoupling plans tend to reduce investor risk. (*Md.P.S.C. Order 83085, Dec. 30, 2009, at 278 PUR4th 419; D.C.P.S.C. Order 15710, March 2, 2010, at 280 PUR4th 381.*)

In Nevada, which has been hit harder by the recent recession, the state Public Utilities Commission in a natural gas rate case chose to reduce ROE by 25 basis points to reflect the reduced risk of decoupling. (*Nev.P.U.C. Docket 09-04003, Nov. 3, 2009, at 277 PUR4th 182.*)

In Michigan, however, where unemployment has proven to be particularly severe, the state Public Service Commission rejected calls to reduce the approved ROE for Detroit Edison to reflect the changed risk profile from implementing

a pilot program for revenue decoupling, along with cost trackers for uncollectibles and extraordinary storm expenses. The commission in that case acknowledged that such plans could shift risk from investors to ratepayers, but found that economic conditions in the utility's service area remained uncertain, posing challenges for the utility, and justifying an ROE allowance at the top end of the range deemed reasonable in the financial models presented by the commission staff. (*Mich.P.S.C. Case Nos. U-15768, U-15751, Jan. 11, 2010, at 280 PUR4th 310.*)

Yet there remains another possible wrinkle in the decoupling story. If decoupling plans indeed are favorable for investors, and shift revenue risk to ratepayers, might it be reasonable to assume that investors already have discounted that information—i.e., that investors have already factored this advantage into equity prices, so the lowered risk will show up already in the studies of comparable equity returns that expert witnesses typically will present in retail rate cases?

If so, then no downward adjustment to ROE would be required for a decoupled utility.

In fact, that issue actually did arise in the Delmarva rate case decided in Maryland. In that case, the commission rejected the utility's argument that no downward ROE adjustment was needed because, as the utility claimed, "other commissions have baked [decoupling] adjustments into the published ROEs of comparable utilities."

According to the commission's rate order, the decoupling plan afforded to Delmarva "an enhanced opportunity to earn its rate of return, even though the company has not faced in any meaningful way the business risks the program is meant to mitigate." ■

Phillip S. Cross is *Fortnightly's* legal editor. Email him at pcross@pur.com

ROE Survey Methodology

As in prior years, this year's survey covers cost-of-equity capital determinations by state public utility commissions (PUC) during a recent 12-month period—in this case, the period Sept. 1, 2009, through Aug. 31, 2010. *Fortnightly's* methodology remains similar to its previous ROE surveys; requests for information on the results of recent rate proceedings were sent to both regulators and utility financial officials. In addition, direct examination of the commission rate orders, when available, provides additional information.

The traditional cost-of-service rate case remains as the primary source of information on how utility regulators view the issue of shareholder earnings requirements. Nevertheless, performance-based rate plans and periodic earnings reviews also contain findings about the appropriate ROE for utilities and are reported herein. Explanatory notes accompany most entries, and citations are provided for orders published in Public Utilities Reports, Fourth Series (PUR4th).

The full data from this year's ROE Survey also are available in the *Fortnightly.com* Utilities ROE Survey Online Database, which contains rate-case data from 1996 through 2010. —PSC

FIG. 1

2010 RATE CASE SURVEY

Company	Utility Type	Case, Docket Or Decision	Application Date	Order Date	Test-year End Date	Increase (Decrease) Requested (\$Million)	Increase (Decrease) Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate (%)	Newly Authorized Rate (%)
Arkansas									
Entergy Arkansas, Inc.	Electric	09-084-U	9/4/09	6/23/10	6/30/10	223.2	63.7	9.9	10.2
Arkansas Southwestern Electric Power Co.	Electric	09-008-U	2/19/09	11/24/09	12/31/09	25.3	17.8	10.75	10.25
Arizona									
Arizona Public Service Co.	Electric	E-01345A-08-0172	3/24/09	12/30/09	6/30/09	448.2	344.7	10.75	11.0 ¹
Arizona UNS Gas, Inc.	Gas	E-04204A-08-0571, 280 PUR4th 505	11/7/08	4/14/10	6/30/08	9.48	3.462	N/A	9.5
California									
Pacific Gas & Electric Co.	Electric/Gas	07-05-003 <i>et al.</i>	8/7/09	10/15/10	12/31/09	N/A	N/A	11.35	11.35 ²
PacifiCorp	Electric	09-11-015	11/20/09	9/2/10	12/31/11	8.36	4.06	N/A	10.60 ³
San Diego Gas & Electric Co.	Electric/Gas	07-05-003 <i>et al.</i>	8/7/09	1/21/10	12/31/09	N/A	N/A	10.79	10.79 ⁴
Sierra Pacific Power Co.	Electric	08-08-004	8/1/08	10/29/09	12/31/09	8.91	5.5	11.50	10.70
Southern California Edison Co.	Electric	07-05-003 <i>et al.</i>	8/7/09	10/15/10	12/31/09	N/A	N/A	11.40	11.40
Colorado									
Atmos Energy Corp.	Gas	09AL-507G	7/8/09	1/4/10	12/31/09	3.8	1.9	10.25	10.25
Black Hills/ColoradoElectric Co.	Electric	10AL-008E	1/5/10	7/28/10	8/31/09	22.9	18.0	N/A	10.50
Public Service Co. of Colorado	Electric		5/1/09	12/24/09	12/31/08	180.2	128.3 ⁵	10.50	10.50
Connecticut									
Connecticut Light & Power Co.	Electric	09-12-05, 282 PUR4th 410	1/8/10	6/30/10	6/30/09	177.6	101.9 ⁶	9.4	9.4
District of Columbia									
Potomac Electric Power Co.	Electric	1076, 280 PUR4th 381	5/22/09	3/2/10	12/31/08	44.5	19.8	10.0	9.625 ⁷
Florida									
Chesapeake Utilities Corp.	Gas	090125-GU	7/14/09	1/14/10	12/31/10	2.97	2.78	11.50	10.75
Florida Power &Light Co.	Electric	080677-EI	3/18/09	3/17/10	12/31/10	1044	75.47	11.75	10.00
Florida Public Utilities Co. -Gas Division	Gas	080366-GU	12/17/08	12/28/09	12/31/09	9.92	7.97	11.25	10.85
Progress Energy Florida, Inc.	Electric	090079-EI	3/20/09	3/5/10	12/31/10	499.997	126.212	11.75	10.50 ⁸
Georgia									
Atmos Energy Corp.	Gas	D-30442, 280 PUR4th 567	10/1/09	3/31/10	10/31/10	3.9	2.9	10.70	10.70
Hawaii									
Hawaiian Electric Co.	Electric	2008-0274	5/11/09	8/31/10	N/A	N/A	N/A ⁹		N/A ¹⁰
Hawaiian Electric Light Co.	Electric	2008-0274	5/11/09	8/31/10	N/A	N/A	N/A		N/A
Maui Electric Co.	Electric	2008-0274	5/11/09	8/31/10	N/A	N/A	N/A		N/A
Idaho									
Avista Corp.	Electric	AVU-E-09-01	1/23/09	7/17/09	9/30/08	31.2	12.6	10.5	10.2
Avista Corp.	Gas	AVU-E-09-01	1/23/09	7/17/09	9/30/08	2.7	1.9	10.5	10.2
Illinois									
AmerenCILCA	Electric	09-0306-09-0311 (Cons.)	6/5/09	4/29/10	12/31/08	27.8	2.2	10.65	9.90
AmerenCILCA	Gas	09-0306-09-0311 (Cons.)	6/5/09	4/29/10	12/31/08	8.8	-7.4	10.68	9.40

Source: Fortnightly Research; 2010 RDE Survey Database, Fortnightly.com

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Company	Utility Type	Case, Docket Or Decision	Application Date	Order Date	Test-year End Date	Increase (Decrease) Requested (\$Million)	Increase (Decrease) Granted (\$Million)	Rate of Return on Common Equity	
								Previously Authorized Rate (%)	Newly Authorized Rate (%)
AmerenCIPS	Electric	09-0306-09-0311 (Cons.)	6/5/09	4/29/10	12/31/08	50.6	17.5	10.65	10.06
AmerenCIPS	Gas	09-0306-09-0311 (Cons.)	6/5/09	4/29/10	12/31/08	11.4	-1.7	10.68	9.19
AmerenIP	Electric	09-0306-09-0311 (Cons.)	6/5/09	4/29/10	12/31/08	102.3	15.4	10.65	10.26
AmerenIP	Gas	09-0306-09-0311 (Cons.)	6/5/09	4/29/10	12/31/08	24.9	-11.3	10.68	9.40
MidAmerican Energy Co.	Gas	09-0312, 280 PUR4th 59	6/2/09	3/24/10	12/31/08	3.387	2.7		10.13
Nicor	Gas	08-0363 ¹¹	4/29/08	10/7/09	12/31/09	140.4	80.2	10.51	10.17
North Shore Gas Co.	Gas	09-0166	2/25/09	1/21/10	12/31/10	18.1	13.8	9.99	10.33
Peoples Gas Light & Coke	Gas	09-0167	2/25/09	1/21/10	12/31/10	113.2	69.8	10.19	10.23
Indiana									
Fountaintown Gas Co.	Gas	43753-U	8/5/09	3/17/10	12/31/08	2.2	2.2	11.40	10.20
Northern Indiana Public Service Co.	Electric	43526	8/27/08	8/25/10	12/31/07	28.0	-48.8	13.5	9.90
Westfield Gas Corp.	Gas	43624	12/31/08	3/10/10	3/31/08	6.3	5.9		10.10
Iowa									
Interstate Power & Light Co.	Electric	RPU-2009-0002, 280 PUR4th 1	3/17/09	1/19/10	9/30/09	170.6	83.7	10.70	10.50
MidAmerican Energy	Electric	RPU-2009-0003 ¹²	3/25/09	12/14/09	N/A	N/A	N/A ¹³	N/A	12.20
Kansas									
Atmos Energy Corp.	Gas	10-ATMG-495-RTS	1/29/10	7/30/10	9/30/09	6.0	3.9	N/A*	
Empire District Electric	Electric	10-EPDE-314-RTS	11/4/09	6/23/10	6/30/09	5.2	2.8	N/A*	
Kansas City Power Light	Electric	09-KCPE-246-RTS	9/5/08	6/24/09	12/31/07	71.6	59	N/A*	
Kentucky									
Atmos Energy Corp.	Gas	2009-00354	10/29/09	5/28/10		9.5	6.1	N/A*	
Duke Energy Kentucky, Inc.	Gas	2009-00202	7/1/09	12/29/09	1/31/11	17.5	13.0	10.20	10.375
Kentucky Utilities	Electric	2009-00548	1/29/10	7/30/10	10/31/09	135.3	98.0	10.63	N/A*
Louisville Gas & Electric	Electric	2009-00549	1/29/10	7/30/10	10/31/09	94.6	74.0	N/A*	
Louisville Gas & Electric	Gas	2009-00549	1/29/10	7/30/10	10/31/09	22.6	17.0	N/A*	N/A
Louisiana									
Cleco Power LLC	Electric	U-30689 ¹⁴	7/14/08	10/14/09	6/30/09	-72.3	-93.4	11.25	11.0 ¹⁵
Cleco Power LLC	Electric	U-21496-L ¹⁶	1/31/10	N/A	9/30/09	N/A	N/A	11.25	11.25
Entergy Gulf States Louisiana, LLC	Electric	U-28916	10/8/09	10/14/09	12/31/07	N/A	-3.7 ¹⁷	10.65	10.65 ¹⁸
Entergy Louisiana, LLC	Electric	U-20925	5/15/07	11/17/09	12/31/06	N/A ¹⁹	-12.9 ²⁰	10.25	10.25 ¹⁸
Maine									
Maine Natural Gas Corp.	Gas	2009-67	2/23/09	12/22/09	12/31/09	N/A	N/A ²¹	N/A	10.0 ²¹
Maryland									
Delmarva Power Co.	Electric	9192, 278 PUR4th 419	5/5/09	12/30/09	12/31/08	14.1	7.5	10.00	10.00
Potomac Electric Power Co.	Electric	9217	12/30/09	8/5/10	12/31/09	40.0	7.8	10.00	9.83
Massachusetts									
Massachusetts Electric Co. and Nantucket Electric Co. ²²	Electric	09-39 ^{23,24}	5/15/09	11/30/09	12/31/08	16.67	-25.009 ²⁵	N/A	10.35
Michigan									
Consumers Energy	Electric	U-15645, 278 PUR4th 457	11/14/08	11/2/09	12/31/09	215.0	139.41	10.70	10.70

Source: Fortnightly Research; 2010 ROE Survey Database; Fortnightly.com

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								Previously Authorized Rate (%)	Newly Authorized Rate (%)
Consumers Energy	Gas	U-15986	5/22/10	5/17/10	9/30/10	114.40	65.89	10.55	10.55
Detroit Edison	Electric	U-15768, 280 PUR4th 310	1/26/09	1/11/10	6/30/10	378.00	217.39	11.00	11.00
Michigan Consolidated	Gas	U-15985, 282 PUR4th 1	6/9/09	6/3/10	12/31/10	192.639	118.56	11.00	11.00
Upper Peninsula Power	Electric	U-15988	6/26/09	12/16/09	12/31/10	12.182	6.500	10.75	10.90
Wisconsin Electric Power Co.	Electric	U-15981	7/2/09	7/1/10	12/31/10	42.100	23.465	10.55	10.25
Minnesota									
CenterPoint Energy	Gas	G008/GR-08-1075	11/3/08	3/18/10	12/31/09	59.78	40.8	9.71	10.24 ²⁵
Minnesota Power	Electric	E015/GR-08-415	6/12/08	8/10/09	6/30/09	45.02	20.42	11.60	10.74
Northern States Power dba Xcel Energy	Electric	E002/GR-08-1065, 277 PUR4th 96	11/3/08	12/18/09	12/31/09	156.07	91.38	10.54	10.88
Missouri									
Missouri Gas Energy	Gas	GR-2009-0355, 280 PUR4th 107 ²⁷	4/2/09	2/10/10	N/A	32.4	16.2	10.5	10.0
Nebraska									
SourceGas Distribution LLC	Gas	NG-0060	7/2/09	3/9/10	12/31/08	9.3	1.632	N/A	9.6
Nevada									
Southwest Gas Corp.	Gas	09-04003, 277 PUR4th 182 ²⁸	4/3/09	11/3/09	N/A			10.5	10.15 ²⁹
New Hampshire									
Public Service Co. of New Hampshire	Electric	DE-09-035	6/30/09	6/28/10	N/A	51.00 ³⁰	40.6 ³¹	N/A	9.67 ³²
New Jersey									
New Jersey Natural Gas Co.	Gas	GR07110889	11/20/07	10/3/08	4/30/08	58.36	32.5	11.5 ³³	10.3
New Mexico									
El Paso Electric Co.	Electric	09-00171	5/29/09	12/10/09	12/31/09	12.7	5.5	N/A	N/A*
New York									
Central Hudson	Electric	09-E-0588	7/31/09	6/18/10	3/31/09	15.2	11.8 ³⁴	10.0	10.0
Central Hudson	Gas	09-G-0589	7/31/09	6/18/10	3/31/09	4.0	5.7 ³⁵	10.0	10.0
Consolidated Edison Co.	Electric	09-E-0428	5/8/09	3/26/10	12/31/08	854.4	540.8 ³⁶	10.0	10.15
Orange & Rockland	Gas	08-G-1398, 276 369 PUR4th	11/26/08	10/16/09	6/30/08	17.8	12.839 ³⁷	9.8	10.4
North Carolina									
Duke Energy Carolinas LLC	Electric	E-7, Sub 909 ³⁸	4/29/09	9/7/09	12/31/08	496.046	315.163	11.0	10.7
North Dakota									
Otter Tail Corp.	Electric	PU-08-862	11/3/08	11/25/09	2007	6.1	3.6	14.5	10.75
Oregon									
Avista Corp.	Gas	UG 186	6/25/09	10/26/09	12/31/08	14.2	8.75	10.0	10.1
Idaho Power Co.	Electric	10-064	6/31/09	2/24/10	12/31/09	7.3	5.0	N/A	10.175 ³⁹
PacifiCorp.	Electric	10-022	4/2/09	1/26/10	12/31/10	92.1	41.5	N/A	10.125
Pennsylvania									
Columbia Gas of Pennsylvania	Gas	R-2009-2149262	1/28/10	8/18/10	9/30/10	32.3	12.0	N/A	N/A*
Rhode Island									
Narragansett Electric dba National Grid	Electric	4065, 281 PUR4th 161	6/1/09	4/29/10	12/31/08	65.5	15.5	10.5	9.8

Source: Fortnightly Research, 2010 ROE Survey Database, Fortnightly.com

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								Previously Authorized Rate (%)	Newly Authorized Rate (%)
Narragansett Electric dba National Grid	Gas	3943	4/1/08	1/29/09	9/30/07	20.0	13.7	11.25	10.5
South Carolina									
Duke Energy Carolinas, LLC	Electric	2009-226-E, 279 PUR4th 266	7/27/09	1/27/10	12/31/08	132.9	74.125	12.25	11.0
South Carolina Electric & Gas Co.	Electric	2009-489-E	1/15/10	7/15/10	9/30/09	197.575	101.248	11.0	10.7
South Dakota									
Black Hills Power	Electric	EL09-018	9/30/09	8/11/10	6/30/09	32	15.2	N/A	N/A ⁴⁰
Xcel Energy	Electric	EL09-009	6/30/09	1/12/10	12/31/08	18.6	10.95	11.25 ⁴¹	N/A ⁴⁰
Texas									
Atmos Energy Corp.	Gas	GUD 9869	4/24/09	1/26/10	6/30	7.7	2.7	10.00	10.40
El Paso Electric	Electric	37690	12/9/09	7/30/10	6/30/09	51.6	17.15	12.00	N/A*
Entergy Texas	Electric	37744	12/30/09	8/6/10	6/30/09	198.7	68.0	10.0	10.125
SWEPCO	Electric	37364	8/28/09	4/16/10	3/31/09	75.0	15.0 ⁴²	15.70 ⁴³	N/A*
Utah									
Questar Gas Co.	Gas	09-057-16, 282 PUR4th 273 ³⁸	10/6/09	6/3/10	12/31/10	17.2	2.6	10.0	10.35
Rocky Mountain Power	Electric	09-035-23, 279 PUR4th 1	4/16/09	2/18/10	5/15/09 ⁴⁴	66.88	32.4	10.6	10.6
Vermont									
Green Mountain Power Co.	Electric	7585, 281 PUR4th 466 ⁴⁵	12/10/09	4/16/10	N/A			9.69	9.94 ⁴⁶
Virginia									
Appalachian Natural Gas Distribution Co.	Gas	PUE-2009-00026 ³⁸	8/19/09	5/4/10	12/31/09	0.2173	0.2173	N/A	11.5
Kentucky Utilities	Electric	2009-00029	6/3/09	3/4/10	12/31/08	12.2	11.0 ⁴⁷	13.0	10.5
Washington									
Avista Corp.	Electric	UC-090134, 279 PUR4th 77	1/23/09	12/22/09	9/30/08	69.8	12.10	10.2	10.2
Avista Corp.	Gas	UG-090135, 279 PUR4th 77	1/23/09	12/22/09	9/30/08	4.9	0.56	10.2	10.2
PacifiCorp.	Electric	UE-090205	2/9/09	12/6/09	6/30/08	38.5	13.5	10.2	10.2
Puget Sound Energy	Electric	UE-090704, 281 PUR4th 329	5/8/09	4/2/10	12/31/08	148.1	56.2	10.15	10.1
Puget Sound Energy	Gas	UG-090705, 281 PUR4th 329	5/8/09	4/2/10	12/31/08	27.2	10.1	10.15	10.1
West Virginia									
Hope Gas, Inc.	Gas	08-1783-G-42T, 277 PUR4th 410	10/16/08	12/20/09		34.4	8.78	N/A	9.45
Monongahela Power Co./ The Potomac Edison Co.	Electric	09-1352-E-42T ⁴⁸	8/13/09	6/25/10	12/31/08	122.1	60.0	10.5	N/A*
Mountaineer Gas Co.	Gas	09-0878-G-42T	6/1/09	3/19/10	12/31/08	26.36	16.0	N/A*	
Wisconsin									
Madison Gas & Electric Co.	Electric	3270-UR-116	4/29/09	12/22/09	12/31/09	16.0	11.9	10.8	10.4
Madison Gas & Electric Co.	Gas	3270-UR-116	4/29/09	12/22/09	12/31/10	4.4	-1.5	10.8	10.4
Northern States Power Co.	Electric	4220-UR-116	6/1/09	12/22/09	12/31/10	30.4	6.4 ⁴⁹	10.75	10.4
Northern States Power Co.	Gas	4220-UR-116	6/1/09	12/22/09	12/31/10	0 ⁵⁰	0	10.75	10.4
Wisconsin Electric Power Co.	Electric	05-UR-104	3/13/09	12/18/09	12/31/10	126.6	85.8	10.75	10.4
Wisconsin Electric Power Co.	Gas	05-UR-104	3/13/09	12/18/09	12/31/10	22.1	-2.0	10.75	10.4
Wisconsin Gas Co.	Gas	05-UR-104	3/13/09	12/18/09	12/31/10	38.8	5.7	10.75	10.5

Source: Fortnightly Research; 2010 RUC Survey Database; Fortnightly.com

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								Previously Authorized Rate (%)	Newly Authorized Rate (%)
Wisconsin Power & Light Co.	Electric	6680-UR-117	5/8/09	12/18/09	12/31/10	85.5	58.6	10.8	10.4
Wisconsin Power & Light Co.	Gas	6680-UR-117	5/8/09	12/18/09	12/31/10	6.2	5.6	10.8	10.4
Wyoming									
Black Hills Power	Electric	20002-75-ER-09	10/19/09	8/13/10	6/30/09	3.819	3.143	12.20	10.5
Montana Dakota Utilities	Electric	20004-81-ER-09	8/14/09	5/26/10	12/31/08	5.054	2.652	10.87	10.0
Rocky Mountain Power	Electric	20000-352-ER-09	10/2/09	7/29/10	12/31/10	70.919	35.51 ⁵¹	10.25	10.25

* Settlement agreement. ROE not specified.

Source: Fortnightly Research; 2010 ROE Survey Database, Fortnightly.com

Notes:

- ROE Figure stated in order approving modified settlement agreement.
- Cost of capital governed by trigger mechanism tied to interest rate index.
- Approved settlement agreement. ROE stated in PUC order.
- Order granting request to forgo "transition" increases in authorized cost of capital for 2010 based on projected increase in interest rate index for 2009. Utilities said increases caused by bankruptcy of Lehman Brothers in 2008 and would likely be reversed in a year's time. Utilities to defer scheduled cost-of-capital filing to 4/20/12.
- Due to delay in operation of utility's Comanche 3 electric generating plant, \$61.4 million withheld from revenue requirement until plant comes on-line.
- Figures shown are cumulative for two-year rate plan. Utility awarded an increase of \$63.4 million in 2010 and an additional \$38.5 million for 2011.
- Figure shown includes a 50-basis-point downward adjustment for reduced risk associated with the operation of a revenue decoupling mechanism.
- Figure includes base-rate increase for the Bartow Repowering Project that was authorized in Order No. PSC-09-0415-PAA-El, issued June 12, 2009 in Docket No. 090144-El. Base rates frozen through 12/31/12 unless ROE falls below 9.5%.
- Order approving a revenue decoupling plan for HECO, Inc. utility companies. PUC directs utilities to submit revenue requirement data reflecting a reduced rate of return due to lowering of risk associated with the plan. New rates will become effective as PUC completes pending rate cases.
- Authorized ROE will be a weighted rate approved in prospective rate proceedings in most recent rate case. ROE applied under above-authorized decoupling plan. First 100 points actual booked ROE over authorized ROE results in 25% sharing credit to ratepayers. Next 200 produces a 50% credit. Earned ROE exceeding 300-basis points above authorized rate produces a 90% credit.
- Order on rehearing.
- Commission approved non-unanimous settlement agreement regarding advanced ratemaking principles to be applied in wind-power project review cases.
- Utility currently operating under a rate freeze through 2012.
- Base Rate Case. Data of vote at the LPSC Business and Executive Session.
- Figure shown is midpoint of approved range of 10.7% to 11.3%.
- Proceeding to review level of earnings under formula rate plan.
- Refund under settlement agreement resolving remaining issues in company's 2007 test year formula rate plan.
- Formula rates reset to achieve ROE shown.
- Order adopting new formula rate plan to be in effect for three years based on the results of operations for 2008, 2009 and 2010 test years.
- Refund under settlement agreement resolving remaining issues in company's 2006 test year formula rate plan.
- Settlement agreement. Step increase of 12% (1/1/10), 10% (12/1/10) and 10% (12/1/11). Second and third step increases subject to "gross margin test." If margin as measured each rate year exceeds stated starting point by 15% or more, step increase postponed if ROE to exceed 10% pending further review.
- Both utilities doing business as National Grid. Rates for both companies made identical after acquisition of Nantucket Electric by New England Electric System, predecessor holding company of National Grid.
- Order approving rate reduction and a revenue decoupling plan pursuant to guidelines developed in a separate generic proceeding.
- Company also proposed implementation of a full revenue decoupling plan with no adjustment to current revenues.
- By order on rehearing dated 4/13/10, company ordered to reduce rates by an additional \$1.68 million.
- Includes effect of approval of partial decoupling.
- Partial settlement agreement. ROE litigated along with issues pertaining to rate design and energy efficiency.
- Findings revised on rehearing. Order issued 12/21/09. Company directed to calculate new rates incorporating findings.
- Reflects reduction in risk as result of approval of revenue decoupling plan.
- Figure shown is for permanent annual rate increase. Company also request additional step increase of \$17 million effective 7/1/10.
- Approved settlement agreement authorizing initial increase figure shown to resolve revenue deficiency and step increases of \$12.2 million for July 1, 2010. Further increases dependent on future plant additions.
- Earnings above 10% ROE triggers progressive sharing mechanism.
- As reflected in January 1994 rate order.
- A rate increase of \$11.8 million rate year 1, \$9.3 million rate year 2 and \$9.1 million rate year 3. Rate plan updates. Plan includes earnings-sharing mechanism.
- A rate increase of \$5.7 million rate year 1, \$2.3 million rate year 2 and \$1.6 million rate year 3. Rate plan update. Plan includes earnings-sharing mechanism.
- A rate increase of \$540.8 million rate year 1, \$306.5 million rate year 2 and \$280.2 million rate year 3 to be levelized on a 3-year basis at \$420.4 million each year (equating to approx \$1,261.2 million over the term of the agreement). Plan includes earning sharing mechanism.
- A rate increase of \$12.839 million rate year 1, \$5,238 million rate year 2 and \$4,479 million rate year 3 to be levelized on a 3-year basis at \$8.964 million each year (equating to approx \$26.892 million over the term of the agreement). Rate plan update.
- Settlement agreement.
- Figure stated in approved settlement agreement.
- Settlement agreement ROE figure treated as confidential.
- Figure from 1992 rate order.
- Does not include \$10 million one-year surcharge for vegetation management.
- Authorized in 1984.
- Test period set by commission in separate order under rate-case scheduling regulations.
- Order approving successor alternative rate plan. Plan permits annual rate adjustments to reflect changes in operating costs.
- Subject to ROE adjustment mechanism.
- Per settlement agreement.
- Joint filing.
- Increase offset by a \$6.4 million fuel cost refund.
- No increase was requested. Staff's audit indicated that present rates were reasonable.
- Amount shown applied in two phases; \$25.5 million effective 7/1/10; \$10 million effective 2/1/11.

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November 25, 2008

Credit FAQ:

Standard & Poor's Assessments Of Regulatory Climates For U.S Investor-Owned Utilities

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Frequently Asked Questions

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Credit FAQ:

Standard & Poor's Assessments Of Regulatory Climates For U.S Investor-Owned Utilities

Based on Standard & Poor's Ratings Services' experience in rating U.S. investor-owned utilities, we believe that the fundamental regulatory environment can be one of the most important factors we analyze when assigning utility credit ratings. So, earlier this month we released our assessments of the credit-supportiveness of the regulatory environments in the primary jurisdictions that regulate the U.S. utilities we rate (see "Assessing U.S. Utility Regulatory Environments," published Nov. 7, 2008, on RatingsDirect). The following answers to frequently asked questions aim to provide additional information regarding how we evaluate the jurisdictions, how we incorporate the assessments into our ratings, and why we decided to create the assessments in the first place. The appendix includes a table of the assessments and a map highlighting each jurisdiction in the U.S to which we have issued an assessment.

Frequently Asked Questions

Why has Standard & Poor's decided to publish these assessments now?

We believe that the effect of regulatory risk on U.S. investor-owned utility ratings has grown in recent years, as has the importance of providing more transparency to the market and policymakers about our approach to analyzing regulatory risk.

We expect the importance of regulatory matters will continue to occupy a primary position in our analysis because the impulse toward deregulation has fallen, the utilities' costs have increased in magnitude and volatility, and utilities are facing ever-greater environmental burdens to meet broad societal and global goals. We believe that regulatory environments around the country must continue to evolve to address those burdens if credit quality is to be preserved. The intent of the Nov. 7 commentary and assessments is to better communicate how regulatory policy and practices affect credit quality.

Are you changing your methodology for rating U.S. investor-owned utilities with the new assessments?

No. Our ratings on a utility will continue to be tied to the utility's own regulatory risk, which depends on more than just the regulatory environment (or environments) where it operates. Management's attitude and capabilities with respect to managing regulatory risk, strategic imperatives, operating performance, and other factors can affect our conclusion on regulatory risk as much as our assessment of regulatory climate.

How do you factor regulation into the credit ratings of U.S. utilities?

The influence of regulatory decisions on the ability of utilities to produce predictable cash flow is a key factor in our credit analysis. Regulation generally supports investment-grade credit quality. The average rating for U.S. investor-owned utilities is 'BBB', while the average for the rest of corporate ratings is in the 'BB' range.

How will you use the assessments when reviewing ratings of U.S. utilities?

The assessments will be the starting point for our rating committee when it reviews a company's regulatory risk profile. We expect the assessments to enhance comparability in ratings across the U.S. utility sector by providing a common and explicit foundation for the evaluation of each utility's regulatory risk. The assessments will also help rating committees evaluate overall management because they will highlight situations where our assessment of a

company's regulatory environment and our view of the company's regulatory risk don't match. Our view of management could be affected if a utility struggles to earn its authorized return in a supportive regulatory environment, or if it financially out-performs its peers in a difficult environment.

What are the assessments trying to measure?

The assessments attempt to measure the fundamental posture of a jurisdiction's policymakers toward issues that matter to a utility's creditors. Standard & Poor's identified many features of regulation that we believe reveal that posture, and gathered data on those factors. To the extent we used qualitative factors to form our opinion, we looked for long-term, institutional characteristics of the jurisdiction such as history of attention paid to credit quality, as well as more recent, possibly transient developments, such as the latest election results. Some important aspects of the assessments to be kept in mind include:

- The assessments are of the whole jurisdiction, not just the regulatory body.
- The assessments are done on an absolute basis, not on a relative scale.
- The assessments are made from a credit perspective.

What specific factors did you use to make the assessments?

The Nov. 7 commentary contains a full discussion of the various elements that Standard & Poor's analyzed in the assessments, but below is an abridged list of the factors, which we've grouped under four broad categories mentioned in the commentary. We give the most weight to the financial stability factors, followed in order by ratemaking factors, political factors, and the regulatory paradigm:

Ratemaking factors

- Cost recovery and earned returns,
- Ratemaking timeliness,
- Resource procurement process,
- Oversight of large capital commitments, and
- Nontraditional ratemaking practices.

Political factors

- Method of commissioner selection,
- Record of political influence, and
- Behavior of influential intervenors.

Financial stability factors

- Rate treatment of large capital expenditures,
- Rate treatment of large expenses,
- Cash flow metrics of regulated utilities, and
- Rate design.

In Standard & Poor's view, is a jurisdiction described as "More Credit-Supportive" one in which the commission is a "good" regulator? Similarly, is one in the "Least Credit-Supportive" category viewed by Standard & Poor's as a "poor" regulator?

No, not at all. First, remember that the assessments encompass much more than the behavior of the regulators in a jurisdiction. Second, all jurisdictions are described as "credit-supportive" and differ only in degree rather than in kind. And third, we designed the assessments to portray utility regulation in terms of its effect on credit quality.

Public policy in a given jurisdiction, as dictated by the executive and legislative branches and implemented by the regulatory body, is properly governed by many different considerations that may or may not coincide with a particular level of creditworthiness. We don't intend the assessments to advocate for any specific ratemaking treatment or commission policy. They merely reflect our opinion of the credit consequences of those policies and other elements of our assessment methodology.

Why are no jurisdictions categorized as Most Credit-Supportive?

We make the assessments against an absolute standard of the degree of credit support. At this time, there are in our view no U.S. jurisdictions that qualify for the top category.

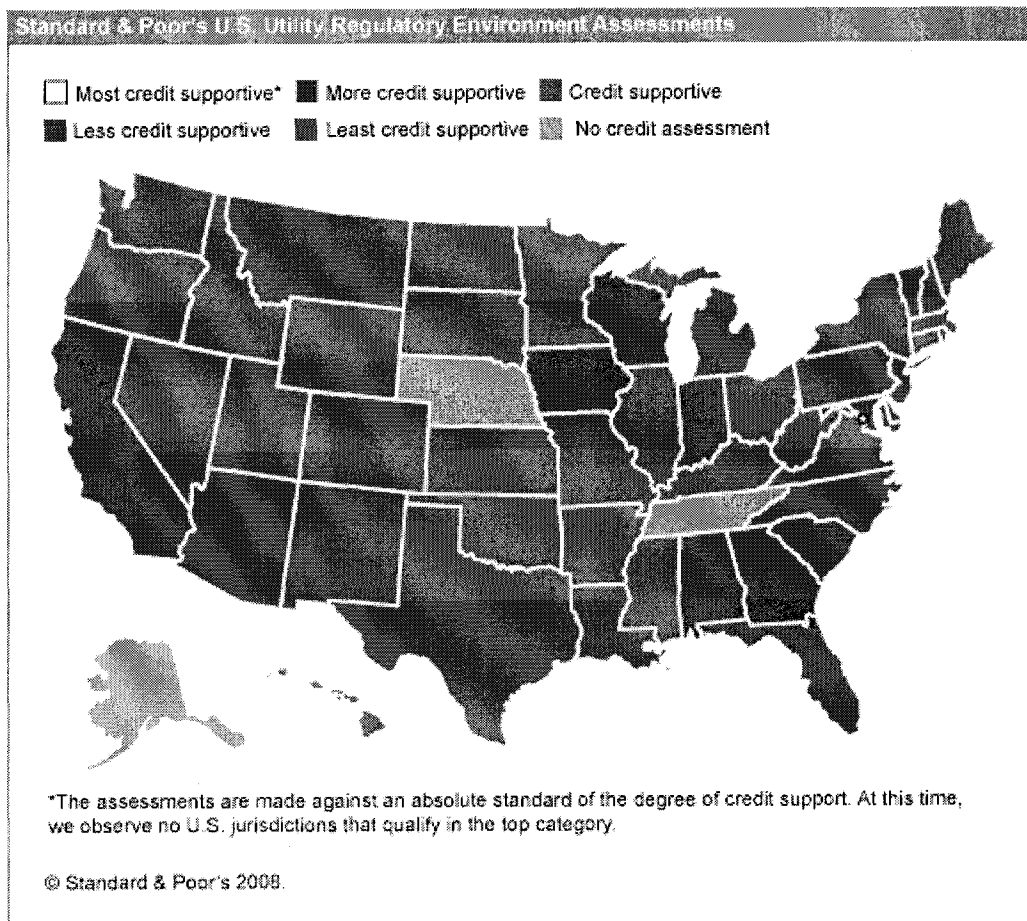
Appendix

Regulatory Assessments For Utilities Among U.S. States

Most credit supportive*	More credit supportive	Credit supportive	Less credit supportive	Least credit supportive
	Alabama	Arkansas	Louisiana	Arizona
	California	Colorado	Maine	Delaware
	Florida	Connecticut	Missouri	Dist. of Columbia
	Georgia	Hawaii	Montana	Illinois
	Indiana	Idaho	New York	Maryland
	Iowa	Kansas	Oklahoma	New Mexico
	South Carolina	Kentucky	Rhode Island	
	Wisconsin	Massachusetts	Texas	
		Michigan	Utah	
		Minnesota	Vermont	
		Mississippi	Washington	
		Nevada	West Virginia	
		New Hampshire	Wyoming	
		New Jersey		
		North Carolina		
		North Dakota		
		Ohio		
		Oregon		
		Pennsylvania		
		South Dakota		
		Virginia		

*In Standard & Poor's view, no U.S. jurisdictions qualify for the top category.

Credit FAQ: Standard & Poor's Assessments Of Regulatory Climates For U.S Investor-Owned Utilities



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